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ABBREVIATIONS

EOL	Economic Opportunity Loan
FTC	Federal Trade Commission
GAO	General Accounting Office
SBA	Small Business Administration

Item 546-5 GAI.13:CED-80-47

REPORT BY THE

Comptroller General

OF THE UNITED STATES

COMPLETED ORIGINAL

Small Business Administration Franchise Loans: Risk Of Loss Can Be Reduced And Program Effectiveness Improved

The Small Business Administration accepts greater risks than necessary by

--not requiring franchisors (companies selling franchises) to guarantee repayment of loans or share SBA guarantees of bank loans as a condition of agency lending,

--accepting weak types of collateral, and

--guaranteeing most bank loans at the maximum percentage instead of negotiating for a lower percentage.

Also, SBA needs to improve loan approval practices to make sure that legal requirements and Federal regulations are enforced and to better assist franchise borrowers.

CED-80-47
APRIL 11, 1980

(79)

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-197763

The Honorable Benjamin S. Rosenthal
Chairman, Subcommittee on Commerce,
Consumer, and Monetary Affairs
Committee on Government Operations
House of Representatives

The Honorable Anthony (Toby) Moffett
House of Representatives

In response to your February 1979 joint request, we reviewed the Small Business Administration's franchise loan policies and practices. We focused on the specific questions in the request.

This report identifies several improvements that can be made in the Small Business Administration's policies and practices to reduce its risk of loss and improve the effectiveness of loans made to franchise businesses.

As requested, we did not obtain written agency comments, but the matters covered in the report were discussed with agency officials. Their oral comments were included in the report where appropriate.

As arranged with the chairman's office, we do not plan to distribute this report further until hearings are held or your offices announce its contents. Should hearings be postponed, however, we will send copies to the agency and other interested parties on request 30 days after the date of the report.

Comptroller General
of the United States

A

COMPTROLLER GENERAL'S
REPORT TO
THE CHAIRMAN, SUBCOMMITTEE ON
COMMERCE, CONSUMER, AND MONETARY
AFFAIRS, COMMITTEE ON GOVERNMENT
OPERATIONS, AND
THE HONORABLE ANTHONY (TOBY) MOFFETT
HOUSE OF REPRESENTATIVES

SMALL BUSINESS ADMINISTRATION FRANCHISE LOANS: RISK OF LOSS CAN BE REDUCED AND PROGRAM EFFECTIVENESS IMPROVED

D I G E S T

The Small Business Administration (SBA) needs to make several changes in its franchise loan policies and practices to minimize risk of loss on loans it makes and guarantees and to improve program effectiveness.

As of April 1979, the most current data available, SBA had made or guaranteed about 16,400 loans totaling about $1 billion to franchise businesses--those licensed to sell products or services under another business' name or trademark. GAO's review included 92 loans in 10 of SBA's 81 field offices that were made to automobile dealers, gasoline stations, and fast food franchises--the types of businesses that received most SBA franchise loans. There is no assurance the results of GAO's review are representative of all franchise loans.

As of September 1978, SBA's risk of loss on franchise loans was about $548 million--the agency's share of outstanding loan balances. SBA unnecessarily bears most of the risk because it

--has not required franchisors to (1) share bank loan guarantees with SBA or (2) guarantee SBA direct loans to franchise borrowers (see p. 6);

--often accepts weak types of collateral as security since it is not viewed as the primary factor in approving loans (see p. 10); and

--frequently guarantees franchise bank loans at the maximum legal rate allowed (90 percent) because no real effort is made to negotiate a lower percentage with the banks (see p. 12).

Tear Sheet. Upon removal, the report cover date should be noted hereon.

A GAO questionnaire sent to 94 nationally known franchisors (see app. II) showed that almost all of the 75 that responded "generally oppose" or "strongly oppose" a policy whereby SBA would require them to guarantee loans. However, 9 of 74 responding to one question said they had guaranteed bank loans made to new franchise borrowers; many said they do not primarily because loan funds are available elsewhere without their guarantees. (See p. 60.)

Other than the borrower, the franchisor benefits most from the success of the franchise. Yet, he may often suffer little loss from its failure. Franchisors would have more incentive to ensure the financial success of SBA borrowers if they were required to share the burden of loss with SBA.

SBA LOAN APPROVAL PRACTICES NEED TO BE IMPROVED

Although GAO believes that SBA's franchise guidelines are adequate to ensure loan payment, its practices and procedures were not always followed.

SBA has not complied with Federal regulatory requirements to obtain proof of bank refusal for loans and therefore may not be acting as a lender of last resort as the law requires. Such proof was obtained for only 7 of 92 loans reviewed. Although the regulations require that this proof include the loan date, terms, amount requested, and bank reasons for refusal, SBA officials believe that a statement by a bank that it will not make a loan without an SBA guarantee is sufficient proof. (See p. 21.)

Also, SBA does not require that franchisors be considered as potential loan sources even though some of them, such as automobile manufacturers, have subsidiary credit corporations that make loans to franchise dealers. Because these dealers comprise a large part of SBA franchise borrowers, SBA could (1) possibly reduce its loan volume and (2) make sure it was not providing loans to borrowers that were able to obtain loans elsewhere by

requiring these dealers to seek financial assistance from the credit corporations before becoming eligible for SBA assistance. (See p. 25.)

SBA obtained credit information on franchisors in only 2 of 92 loan files reviewed, and 26 files did not contain credit reports on the borrowers. This lack of information increases SBA's potential for loss. Also, about 67 percent of the loan files did not contain franchise agreements--essential documents for determining borrower eligibility for an SBA loan and whether franchisor-imposed financial requirements inhibit a borrower's ability to pay the loan. District officials said SBA regulations do not require that financial analyses be made or credit information obtained on franchisors. Concerning franchise agreements, one district relies on banks to review them and another district reviewed them only when copies were provided. (See p. 28.)

FRANCHISE BORROWERS COULD BE BETTER ASSISTED

Although SBA provides some information, counseling, and management assistance to franchise borrowers, improvement is needed to ensure loan payment. SBA does not provide the prospective borrowers information on franchisors to assist them in making a decision on the business, such as SBA's loan experience with other borrowers of the same franchisor. Also, SBA does not always provide useful and timely counseling and assistance to these borrowers.

SBA has loan failure data in its files, but it is not in a useful form. Such information could reduce the potential for loan defaults by (1) dissuading prospective franchise borrowers from entering into risky businesses and (2) alerting SBA loan staff to those companies that have high default records. (See p. 43.)

SBA field visits are important in identifying borrower financial difficulties and whether management assistance is needed. These visits, however, were not made in accordance with operating procedures for 50 percent of

the loans GAO reviewed. SBA officials attributed this to staff shortages. (See p. 48.)

RECOMMENDATIONS TO THE ADMINISTRATOR

The Administrator, SBA, should require that:

--SBA not make or guarantee franchise loans unless it has evidence that the franchisor cannot guarantee all or part of SBA direct loans or share with SBA guarantees of bank loans.

--SBA not make or guarantee franchise loans if the franchisor can provide financial assistance on reasonable terms.

--Before approving loans, district offices obtain proof of refusal by banks and others to make loans, including the date, amount and terms requested, and the reason for refusal, as required by Federal regulations.

--District offices obtain and review franchise agreements in all cases to ensure that provisions in the agreements do not make prospective borrowers ineligible for loans or unduly restrict the borrowers' repayment abilities.

See pp. 15, 40, and 53 for other recommendations.

AGENCY COMMENTS

SBA officials commenting on the report generally disagreed that SBA should take some of the GAO recommended actions for various reasons, including their belief that (1) franchisors would not agree with these actions, which would decrease the number of franchise loans SBA makes, (2) SBA already obtains sufficient proof of loan refusal by banks and other non-Federal sources, and (3) franchise agreements were being reviewed as required.

GAO's recommendations, if implemented, may cause some loan applicants not to apply for an SBA loan who otherwise would. The effect of GAO's

first recommendation on SBA's franchise lending activity is difficult to project. However, some franchisors are already providing direct loans or guaranteeing SBA or bank loans.

The proof of loan refusal SBA is obtaining is not adequate in most cases because it does not include terms and conditions prospective borrowers requested or lenders' reasons for refusal, as Federal regulations require.

Concerning district offices' reviews of franchise agreements, GAO noted that these agreements were not being obtained and reviewed in most cases.

Agency officials did agree to implement GAO's recommendations on defining a franchise, and providing district offices information on franchisor loan failures to assist them in making loan decisions and help reduce the potential for loan losses. Also, these officials agreed that SBA field visits to borrowers were not always being made.

CHAPTER 1

INTRODUCTION

The Chairman, Subcommittee on Commerce, Consumer, and Monetary Affairs, House Committee on Government Operations, and Representative Anthony Moffett, a subcommittee member, requested a review of the Small Business Administration's (SBA's) operations of its 7(a) business loan program as related to franchisees. (See app. I.) We were asked to focus on 22 specific questions covering various aspects of SBA's lending practices and policies applicable to franchise businesses. Our review results are presented in chapters 2 through 4 of this report.

FRANCHISING OVERVIEW

The franchise method of doing business has been described as a system used by a company (franchisor) which grants to others (franchisees) the right and license (franchise) to market a product or service and engage in a business developed under the franchisors' trade names, trademarks, service marks, know-how, and method of doing business.

Franchising in the United States is growing into a dynamic and mature business activity, according to a January 1979 report 1/ published by the Department of Commerce Industry and Trade Administration. The report states that franchising has become highly attractive to many large corporations as a means of diversification. Franchise sales of goods and services were expected to reach $299 billion in 1979, while the number of establishments (franchises) would be about 492,000. Of this, about $267 billion, or about 90 percent, was expected to come from retail sales. Auto and truck dealers and gasoline stations were expected to account for $217.5 billion, or about 81 percent, of all franchise retail sales.

The Industry and Trade Administration report points out that there are two basic types of franchising: (1) "traditional" franchising and (2) "business format" franchising. Typically, traditional franchising consists of automobile and truck dealers, gasoline service stations, and soft drink bottlers. This type of franchising dominates the field, accounting for almost 77 percent ($229 billion) of all franchise sales in 1979, according to the agency report.

1/"Franchising in the Economy, 1977-1979."

Business format franchising is described in the report as a fully integrated relationship that includes not only product, service, and trademark but also a marketing strategy and plan, operating manuals and standards, and quality control. Typical businesses are the fast food restaurant, nonfood retailing, and lodging. Sales for this type of franchise were expected to be about $70 billion in 1979.

In recent years the trend in franchising reflects an increase in conversions of company-owned units to franchisee ownership. For example, the Industry and Trade Administration report shows that in 1977, the latest statistics available, 619 franchise units were repurchased for company ownership, but 839 were converted to franchisee ownership.

SBA FRANCHISE LOANS

SBA had made an estimated 16,379 loans totaling about $1 billion to franchises from 1959, when the first loan was made, through April 1979. Loans totaling about $65 million were in liquidation and $27 million had been charged off as of that date. The actual number of franchise loans made could not be determined because some SBA district offices did not properly classify and report all such loans. This problem is discussed more fully in chapter 3 of this report.

Most (89 percent) of SBA's franchise business loans have been made under its principal business loan program--the 7(a) program authorized under the Small Business Act, as amended (15 U.S.C. 636(a)). Another 9.5 percent have been made under SBA's Economic Opportunity Loan (EOL) program.

SBA 7(a) Loan Program

Under the 7(a) program SBA makes or guarantees small business loans to finance plant construction, conversion, or expansion; to purchase equipment, facilities, machinery, supplies, and materials; and to provide working capital. To be eligible for a 7(a) loan, a firm must be independently owned and operated and meet the small business size standard that SBA established for the firm's industry. The size standard is usually expressed in number of employees or annual sales. A franchise business is considered to be independently owned and operated, and therefore eligible under this program, if the franchisee has the right to that profit from his or her effort which an owner of a business generally expects and bears the risk of loss or failure. The business must also meet the eligibility size standard established for that particular type of business.

Three types of loans are made under the 7(a) program--guaranteed, immediate participation, and direct. A guaranteed loan is made by a private lending institution with SBA guaranteeing up to 90 percent of the loan in case of borrower default. A maximum of $500,000 may be loaned. The guaranteed loan interest rate is established by the private lender, subject to a maximum SBA-established rate. SBA's maximum rate is 0.5 percent above the minimum prime rate as quoted in the Wall Street Journal on receipt of the application. An immediate participation loan is made by either SBA or the private lending institution, with the other party purchasing an agreed percentage of the loan upon disbursement. SBA's share of an immediate participation loan generally cannot exceed 75 percent of the loan amount. SBA also makes direct loans without private lender participation. The interest rate on these loans is 8-1/4 percent for fiscal year 1980.

Under the terms of the Small Business Act, SBA may not make an immediate participation loan unless no guaranteed loan is available. It may not make a direct loan unless no immediate participation loan is available. The maturity of 7(a) loans may not exceed 10 years, except for that portion of a loan made to acquire real property or construct facilities, in which case the loan may have up to a 20-year maturity.

Guaranteed loans account for about 64 percent of loans made under the 7(a) loan program. Likewise, about 83 percent of all franchise loans SBA has made since program inception were guaranteed loans.

Economic Opportunity Loan Program

The Economic Opportunity Act of 1964 (Public Law 88-452) established the EOL program to help improve economic conditions in low-income areas, increase small business ownership opportunities for the socially or economically disadvantaged, and create jobs in these areas. Section 7(i) of the Small Business Act, as amended, authorizes SBA to make, participate in, or guarantee loans under the program. EOLs are restricted to low-income individuals or persons who, due to social or economic disadvantage, have been denied the opportunity to acquire adequate business financing through normal lending channels on reasonable terms. Where there are two or more principals, the applicant is considered eligible if 50 percent or more of the business is owned by qualified persons.

According to SBA procedures, the credit criteria for EOLs are liberal and involve taking "calculated risks." The procedures state that every effort should be made to find a

basis for approving loans and that inadequate collateral shall not be used as a reason for declining a loan unless the applicant refuses to pledge whatever worthwhile collateral is available. Reasonable assurance of repayment, however, must be determined. SBA's share of an EOL is limited to $100,000 and must be repaid within 15 years.

As of April 1979 about 1,560 EOLs totaling almost $25 million had been made to franchises, or about 2.5 percent of the dollar amount loaned under the program.

Program administration

SBA administers the 7(a) and EOL programs through a headquarters office, 10 regional offices, and 81 district and branch offices. The headquarters office is responsible for developing and recommending agencywide program policies, reviewing and evaluating program effectiveness, and providing technical guidance to regional offices. The regional offices supervise district office operations, evaluate district office performance, review requests for reconsideration of loan applications, and provide technical guidance to district offices.

The district offices, each headed by a director and under the jurisdiction of the regional offices, are responsible for the day-to-day operations of the 7(a) and EOL programs. Within the district office, the

--financing division is responsible for reviewing loan application packages and recommending approval or disapproval;

--portfolio management division is responsible for servicing loans, referring loans to the management assistance division, and representing SBA at foreclosure;

--management assistance division is responsible for providing management assistance to loan applicants and borrowers through the division's own resources or arranging for such assistance through the professional expertise of the Service Corps of Retired Executives (SCORE), the Active Corps of Executives (ACE), the Small Business Institute (SBI), a consultant contractor, or others.

Our review of 92 loans in 10 of SBA's 81 field offices (see p. 55) revealed a number of matters that need improving.

This review, however, focused primarily on matters of interest to the subcommittee, rather than making an overall evaluation of the program.

PREVIOUSLY ISSUED REPORTS

We have issued two other reports on the 7(a) loan program since 1976 (see p. 12), which address some of the matters discussed in chapters 2 through 4 of this report.

CHAPTER 2

SBA IS TAKING GREATER RISK THAN NECESSARY ON LOANS TO FRANCHISEES

We found that SBA (1) does not consider franchisors as guarantors of SBA direct loans to franchisees or, at a minimum, as partners in sharing SBA guarantees of bank loans made to franchisees, (2) accepts collateral of questionable value, and (3) guarantees the maximum allowed (90 percent) of almost all bank loans made to franchisees. As a result, SBA is taking greater risk of loss on franchise loans than necessary. The SBA outstanding direct loan balance and its share of outstanding guaranteed bank loans totaled about $548 million at September 30, 1978--the most current data available.

We were asked to answer the following specific questions concerning these matters.

> "Has SBA considered requiring large franchisors to extend or guarantee credit to a franchisee as a condition for its own lending to the franchisee?"
>
> "If not, why not, and what recommendation would GAO have to remedy this situation?"

FRANCHISORS NOT CONSIDERED AS LOAN GUARANTORS

SBA policy does not require that franchisors be considered as loan guarantors as a condition of SBA lending to franchisees. Most SBA districts we visited generally do not ask them to be guarantors, but a few franchisors have guaranteed SBA loans. Our discussions with SBA regional and district officials showed mixed reactions to implementing such a policy. Questionnaires sent to franchisors showed that (1) 9 of 74 do in fact guarantee bank loans made to new franchisees and (2) almost all franchisors oppose sharing SBA guarantees or guaranteeing SBA direct loans.

Most districts that we visited generally do not consider asking large franchisors to extend credit (make direct loans) or guarantee credit (guarantee SBA loans) to franchisees as a condition of SBA loans to franchisees, and most district and regional offices are not in favor of requiring it. They believe that problems might arise as to (1) franchisors' decisions to finance only the best franchisees and (2) the question of whether the franchisor or franchisee controls the business.

Of the 92 loan files reviewed in 10 district offices, in no instance did we find that a franchisor had participated in or guaranteed a portion of SBA franchise loans. SBA Northeast district office officials said that SBA generally will not consider requiring large franchisors to extend or guarantee credit to a franchisee as a condition for its own lending to the franchisee. Most of the district officials felt that the question of who controls the business might be raised if the franchisor finances part of the requested loan. However, officials of the SBA Providence district office said that, as a condition of its lending in some instances, it had obtained agreements from franchisors to extend credit to franchisees for payment of franchise fees. SBA Concord district office officials said that, as a condition for making a loan, they may in some circumstances require a franchisor to provide credit to a franchisee on certain items purchased from the franchisor.

Officials in the western districts visited generally did not believe that franchisors should provide partial funding or loan guarantees to franchisees. They said that they believed such financial participation would allow the franchisors too much management jurisdiction over the franchisees' business operations. On the other hand, officials in the Los Angeles district office stated that franchisors would probably be more interested in assuring the franchises' success if they had to participate in guaranteeing the loans.

Phoenix district officials said that it probably would be a good idea to request franchisors to provide partial funding or a loan guarantee in all cases, before SBA loan approval. This office had obtained franchisor guarantees in a few cases. A Des Moines district official, who previously worked in the SBA New Orleans office, said he was told that the latter office had also obtained at least one franchisor loan guarantee for a 3-year period and that another franchisor had recently approached the Des Moines office about guaranteeing SBA loans. Also, an SBA regional director said that he did not like to see a large number of loans to car dealers and gasoline stations because the auto manufacturers and oil companies do not generally support their franchisees. We believe that this may be all the more reason for SBA to seek guarantees from these franchisors.

In addition, we noted that the Los Angeles district office had not sought a franchisor guarantee or agreement on a $30,000, 10-year loan to a franchisee, even though the franchisee only had a 5-year business lease. The San Francisco district has also made at least one loan in which the repayment period exceeded a lease term. In our opinion, this

practice only increases SBA's risk of loss and should be a further incentive to seek franchisor guarantees. SBA's operating procedures state that "Normally, the lease should run at least through the term of the loan."

Although none of the 92 loans we reviewed showed that franchisors had been required to guarantee an SBA franchisee loan, a questionnaire we sent to 94 franchisors (see app. II) revealed that 9 of the 74 answering the question on whether they guarantee bank loans said they did so for loans to new franchisees. One franchisor official stated that in two instances his company was required to give its guarantee. In one case the bank refused to make the loan without the franchisor's guarantee, even though SBA also guaranteed the loan. An SBA loan officer from the district office in question verified this and characterized the bank as very conservative. Also, he said that although franchisor guarantees are not common practice, he knew of a few cases in which Chevron and the Ford Motor Company were required to guarantee SBA loans made to their dealers. He believed that franchisor guarantees should be required on SBA direct and guaranteed franchisee loans.

Almost all the franchisors responding to our questionnaire "generally oppose" or "strongly oppose" either (1) guaranteeing at least part of SBA direct franchisee loans or (2) sharing at least part of SBA's guarantees of franchisee bank loans, as follows.

Table 1

Franchisors' Reactions to a Potential SBA Requirement that They Guarantee at Least Part of the Loan Amount as a Condition of an SBA Direct Loan to Their Franchisees

	Number of franchisors
Strongly support	2
Generally support	1
Generally oppose	18
Strongly oppose	48
Support as much as oppose	3
No response	3

Table 2

Franchisors' Reactions to a Potential SBA Requirement That They Share at Least Part of SBA's Guarantees of Bank Loans to Their Franchisees

	Number of franchisors
Strongly support	1
Generally support	1
Generally oppose	19
Strongly oppose	46
Support as much as oppose	5
No response	3

A substantial number of SBA loans and loan guarantees were made to franchisees of large companies. (See p. 37.) Twenty-seven of these companies, in responding to our questionnaire, stated that lack of financial resources was not the major reason they were not lending and/or guaranteeing bank loans made to their franchisees. Most said that the major reason was that loan funds were available elsewhere. Other than the borrower, the franchisor benefits most from the success of the franchisee through continued product sales and collection of franchise fees and royalties. Yet the franchisor may often suffer no loss, other than perhaps a temporary reduction in income, from the financial failure of a franchisee. We believe that franchisors would have more incentive to assure the financial success of SBA franchisee borrowers if they were required to share the burden of loss with SBA.

Although a few district officials believe that this requirement would be a good idea, they do not believe that franchisors would agree to participate. One franchisor objected to an SBA requirement that franchisors guarantee or share guarantees of SBA franchisee loans because such guarantees would be long-term commitments which would have to be shown as contingent liabilities on his company's financial statements. This would, in his view, weaken the company's financial position. Other franchisors' comments on this potential SBA requirement are included as appendix III.

SBA loans can have a repayment period of up to 20 years. SBA statistics, however, show that almost 80 percent of its

7(a) guaranteed loans that defaulted during fiscal years 1974-78 did so within 3 years after the loans were made. As a result, we believe that franchisor concerns about a long-term commitment can be minimized if SBA would limit franchisor guarantees to 3 years. Such a limitation may reduce significantly SBA's exposure to loss on loans and make a requirement that franchisors guarantee SBA loans, or share SBA guarantees of bank loans, more acceptable to franchisors.

COLLATERAL ACCEPTED IS SOMETIMES QUESTIONABLE

The collateral SBA districts accepted to secure franchise loans was generally of the weaker types. Also, SBA did not usually appraise the collateral. As a result, SBA may have incurred larger losses than necessary on defaulted loans. Our review showed that:

--Forty of the 92 loans reviewed were defaulted loans. The collateral pledged as security for 39 of these 40 loans was primarily of the weaker types--machinery and equipment, furniture and fixtures, inventory, or accounts receivable. Although the collateral for 20 of the loans that were charged off was initially valued at about $1.8 million, SBA realized only about $0.6 million to cover outstanding loan balances totaling about $1.3 million. Collateral value for two more loans charged off could not be determined, and the other 17 defaulted loans secured primarily with weak collateral were in liquidation. In addition to these 39 loans, 47 more of the 92 loans reviewed were partially secured with this type of collateral.

--Collateral for only 7 of the 92 loans was independently appraised.

The Small Business Act, as amended, provides that all loans made shall be of such sound value or so secured as to reasonably assure repayment. SBA operating procedures state that although a loan is not to be denied if the only unfavorable factor is the inadequacy of collateral, the collateral should be of a type, amount, and value which, when considered with other factors pertaining to the business, will afford the required assurance of repayment. The need for independent appraisals of the collateral is to be determined on a case-by-case basis--appraisals furnished by the borrower or the participating bank may be acceptable.

Following are two examples in which the value of collateral initially was much greater than at the time the loans defaulted.

--The SBA Phoenix district office guaranteed 90 percent of a $20,000 franchise loan secured by machinery, equipment, furniture, inventory, and accounts receivable with an initial estimated value of $42,000. After the borrower defaulted about 2-1/2 years later, net proceeds from the sale of the pledged assets totaled only about $2,300.

--The Los Angeles district office guaranteed 90 percent of a $499,500 franchise loan secured by a lien on business assets--machinery and equipment, furniture and fixtures, and inventory with an estimated cost of $303,000--and second deeds of trust on personal real estate valued at $75,000. In less than 2 years the loan defaulted and the business assets were sold for $100,000. At the time of our review, SBA was taking action to acquire the pledged real estate ($75,000) to satisfy a loan balance of about $430,000 (includes accrued interest of $70,000).

Also, we noted that collateral for only 2 of the 40 defaulted loans had been independently appraised. Since it appears that the value of collateral may have been overestimated in several instances at the time the loans were made, an independent appraisal for some of the larger loans may have helped prevent some of the losses.

SBA regional officials said they have no requirement to obtain dollar-for-dollar security for a loan. Although they do prioritize collateral by types, with real estate being the highest priority and inventory and accounts receivable at the lower end of the scale, SBA must accept whatever collateral is available if the borrower has a demonstrated ability to repay the loan. Also, these officials said that banks generally provide SBA with realistic appraisals of collateral, and they did not believe it would be beneficial to require independent appraisals in every case.

District officials stated that collateral is not the primary factor in approving loans. They have to take whatever collateral is available, especially if the pledged assets are being procured with loan proceeds. Since SBA does not have its own appraisers, the banks generally determine the value of collateral pledged to secure loans. We question this practice, however, because banks may have very little incentive to appraise collateral or have independent appraisals made thereof due to SBA's practice of

guaranteeing 90 percent of nearly all bank loans made to franchisees, as discussed in the following section of this report.

In 1976 we reported 1/ that when collateral was appraised, the majority of appraisals were made by banks and that independent appraisers were used in only a small percentage of the cases reviewed. We pointed out that "When collateral is not properly appraised or its existence verified, losses can be higher than anticipated if the borrower defaults on his loan payments." Although we recommended corrective action, our August 1979 followup report 2/ shows that SBA has not made necessary improvements. In commenting on our followup report, SBA said its policy was that

> "* * * loans will not be turned down primarily for lack of collateral. Therefore, a judgment must be made as to how much weight will be given to collateral. If a loan is large and collateral is important, an appraisal should be obtained. If collateral is of minor importance, and the loan is small, the loan officer's 'evaluation' is sufficient.
>
> "* * * we plan to rely on Field Review and Internal Audits to disclose problem areas in specific field offices and we will take appropriate action based on these disclosures."

We believe that SBA, to the extent possible, should be more cautious about accepting weaker types of collateral and should make independent appraisals of collateral pledged for the larger loans to ensure that the value of the collateral is not overestimated.

MAXIMUM GUARANTEE PERCENT FREQUENTLY USED

SBA is guaranteeing almost all franchise loans made at the maximum the law allows--90 percent. As a result, its risk of loss is maximized. SBA, however, may be able to decrease its share of the risk on many loans by using loan history data to negotiate guarantee percentages downward.

1/"The Small Business Administration Needs To Improve Its 7(a) Loan Program" (GGD-76-24, Feb. 23, 1976).

2/"Efforts To Improve Management Of The Small Business Administration Have Been Unsatisfactory--More Aggressive Action Needed" (CED-79-103, Aug. 21, 1979).

The Small Business Act, as amended, provides that SBA may participate in 7(a) loans on a guarantee basis in amounts not to exceed 90 percent of the loan balance, when credit is otherwise unavailable from non-Federal sources. About 83 percent of all guaranteed franchise loans made nationally from program inception through April 1979 were made at the 90-percent rate. Of the 92 loan files we reviewed, 14 were SBA direct loans and 78 were guaranteed loans. Sixty-eight (87 percent) of the 78 loans were guaranteed by SBA for 90 percent of the loan balance, including 31 of the 35 defaulted loans which SBA had guaranteed.

SBA may be able to reduce guarantee percentages on many loans and, therefore, its exposure to loss by getting banks to accept a larger share of loan risks. Generally franchisees to whom SBA has made loans have repaid or are in the process of repaying their loans. Based on the loan repayment records of some franchisees, SBA appears to be in a good position to negotiate a lower SBA-guarantee percentage, or banks should be willing to make loans without an SBA guarantee. Instead, SBA is guaranteeing most loans to these franchisees at the maximum (90) percent.

For example, according to its records, SBA had made or guaranteed 225 loans totaling about $29.6 million to McDonald's franchisees through April 1979. SBA guaranteed about $28.7 million (215 loans) of the $29.6 million these franchisees received. About $26.4 million (203 loans or 94.4 percent of all loans guaranteed) was guaranteed at the maximum percent, although only about $120 had been charged off. Since the risk of loss on loans to McDonald's franchisees is therefore negligible, SBA should be in a good position to negotiate with banks to reduce SBA's share of loan guarantees, which would decrease SBA's risk of loss on many of these loans.

Some district officials said banks know that, generally, SBA's policy is to guarantee 90 percent of loans and would be much more hesitant to make such loans if they had to assume more of the risk. Officials in one district suggested that banks may be willing to assume more risk if they did not have to provide all of the required loan funds. Some district officials, however, said that banks would probably provide better loan servicing if they had to participate in the loan guarantees to a greater extent. A Des Moines district office official said that his office had fewer problems with loans on which banks had taken more than a 10-percent share of the risk. He said that the banks were more cooperative and provided better servicing.

Another reason SBA district offices may have guaranteed most franchise loans at the maximum percent was pressure from SBA headquarters and regional offices to meet lending goals or quotas. A Phoenix district official told us that there was pressure on the district offices from SBA headquarters and regional offices to meet dollar lending quotas. He said that lending quotas, however, made no sense because of the economy's effect on the demand for loans.

When questioned about whether SBA might want to limit the number of 90-percent guaranteed loans in an effort to reduce them, an SBA headquarters division director said that this would be contrary to the current trend in the 7(a) program of giving banks more responsibility. The 7(a) loan guarantee authority SBA will receive is expected to more than triple over the next 5 years--from about $3.5 billion to $11 billion--according to this official. Apparently, SBA does not believe it can handle the program at the planned $11 billion level without significantly expanding the banks' roles, and SBA does not want to take any action to jeopardize its relationship with the banks so that they will take more responsibility.

Also, in an October 25, 1979, letter commenting on recommendations in our August 1979 followup report, SBA said that guaranteed loans were now being emphasized and that the ultimate objective was for SBA to become a "wholesaler" in the lending programs.

In a February 26, 1976, report to SBA's Deputy Administrator on a review of the 7(a) loan program, we pointed out that SBA district offices were not negotiating with banks to reduce the portion of loans to be guaranteed by SBA at 90 percent. This was not being done in spite of the fact that bank officials participating in the program in two SBA district offices included in that review said that they would be willing to accept more than 10-percent exposure on selected loans.

Also, we reported that an SBA district office loan specialist felt that banks would service loans better with more exposure and that a bank's willingness to participate at more than 10 percent was a good test of the bank's confidence in the loan. In addition, an official from the district office said that he did not know of any banks that had stopped participating in 7(a) loans because of his office's negotiating policy. We recommended that SBA encourage its loan specialists to negotiate the 7(a) loan guarantee percentage with banks. No action has been taken, however, to implement this recommendation.

CONCLUSIONS

SBA is taking greater risk of loss than necessary on franchisee loans. It (1) does not consider franchisors as guarantors, (2) accepts weaker types of collateral and does not generally appraise it, and (3) guarantees most loans at the maximum 90 percent.

We believe SBA could significantly reduce its potential for losses. With little or no risk of financial loss, neither the franchisors nor the banks appear to have much incentive to provide additional assistance or guidance to franchisees to assure business success. Therefore, the collateral accepted for these loans becomes even more important to minimize losses when loans default.

RECOMMENDATIONS

To reduce SBA's risk of loss on direct loans to franchisees, as well as SBA-guaranteed bank loans, the Administrator, SBA, should require:

--That SBA not make or guarantee franchise loans unless it has evidence that the franchisor cannot guarantee all or part of SBA direct loans or share with SBA guarantees of bank loans made to franchisees. In carrying out this recommendation, SBA may wish to consider limiting franchisor participation to 3 years--the time within which most small businesses that receive SBA-guaranteed loans fail, according to SBA statistics. We believe that franchisors would be more receptive to this idea if their participation is limited to a short period, rather than the life of the loan.

--District offices to limit, to the maximum extent possible, accepting the weaker types of collateral to secure loans, especially inventory and accounts receivable.

--That district offices have independent appraisals made of coliateral pledged for those loans exceeding a certain amount--for example, $150,000.

--That district offices, using SBA loan history data, negotiate guarantee rates with banks to reduce the number of loans being guaranteed at the maximum 90-percent rate.

AGENCY COMMENTS

The SBA Deputy Associate Administrator for Management Assistance, a division director, and a senior field management officer, with whom we met to obtain oral comments on the report, disagreed with the above recommendations.

With regard to the first recommendation, these officials said they did not believe that franchisors would agree to share SBA loan guarantees or guarantee SBA direct loans. They said that franchisors regard themselves as marketers, not financing institutions, and perhaps the most important reason that even well-financed franchisors do not generally make or guarantee loans is the adverse effect this practice would have on their borrowing capacities or existing agreements with lenders. These officials therefore believe that requiring franchisors to guarantee SBA loans would result in fewer loans to small businesses.

As mentioned in the report, the results of our questionnaire to franchisors show that 9 of the 74 responding to one question already guarantee loans made to franchisees. Also, 46 of 56 responding to a question asking why they did not guarantee loans made to franchisees said the primary reason was that loans were available elsewhere. In addition, we noted that SBA had already obtained franchisor guarantees in some cases.

The SBA officials said, with regard to our recommendation on acceptance of weaker types of collateral, that banks should be evaluating the collateral for most loans since most loans are made by the banks and guaranteed by SBA. They said that SBA accepts whatever value the banks assign to the collateral.

As mentioned in the report, we questioned this practice because of the banks' lack of incentive to realistically appraise collateral or have an independent appraisal made thereof--SBA guarantees 90 percent of bank loans in most cases. The collateral values accepted for many of the loans reviewed appear to have been overstated since SBA recovered only a small fraction of the initial estimated value of collateral when the loans defaulted.

SBA district offices need to be more cautious about the types of collateral accepted and should appraise collateral pledged for larger loans. These actions may help prevent future losses on loans that default.

The SBA officials said that maximum loan guarantees by SBA were the norm and that whether to negotiate the guarantee

percentage traditionally has been left to the judgment of the loan officer processing the loan. The loan officer's success depends upon the quality of the loan applicant and the rapport or relations of a particular field office with a particular bank.

These officials said that in recent years, lenders' increasing secondary market activities--selling the SBA-guaranteed 90-percent portion of loans to others--has made larger percentage guarantees more attractive because (1) the loan-servicing fee SBA pays to these lenders is computed on the guaranteed portion and (2) guaranteed portions are not considered in computing loan-to-deposit ratios. As a result, lenders are willing to accept SBA's interest rate of 0.5 percent above the prime rate rather than the usual 5 percent. The officials said it was not surprising therefore that most guaranteed loans were approved at the maximum percentage. They said that SBA loan officers, however, would continue to attempt negotiation in appropriate situations.

SBA is very concerned about meeting its lending goals, and according to the officials with whom we met, SBA headquarters does emphasize these goals to district offices. SBA officials appeared to disagree with requiring anything which might jeopardize making a loan or affect in any way SBA's relationships with banks. One official said that SBA needed the banks, but the banks did not need SBA.

The Small Business Act, as amended, provides that SBA's participation in loans shall not exceed 90 percent of the loan balance at the time of disbursement. Many loans guaranteed at the maximum percentage probably could have been guaranteed at a lower percentage, which would reduce SBA's exposure to loss. We realize that banks would like to minimize their risks and therefore often ask SBA for a 90-percent guarantee. SBA, however, must protect the Government's interest and, in so doing, make every effort to minimize the potential for losses on loans. In many cases, SBA appears to be in a good position to lower its loan guarantee percentage using loan history data.

CHAPTER 3

LOAN APPROVAL PRACTICES NEED TO BE IMPROVED

SBA's loan approval practices were not always in compliance with its established procedures and regulations and were not adequate to ensure franchise eligibility or loan repayment ability. SBA:

--May be contributing to loans being charged off because of noncompliance with its procedures and regulations.

--May not be acting as a lender of last resort, as the law requires, by not obtaining from banks and other non-Federal sources proof of loan refusal that Federal regulations specify. Also, it may be providing financial assistance to franchisees who could obtain such assistance from non-Federal sources.

--Has not made or obtained marketing studies or credit analyses of franchisors or, in several cases, credit analyses of borrowers.

--Does not have an official definition of a franchise, which could result in (1) inability to apply legal requirements and Standard Operating Procedures to franchise loans and (2) lack of uniformity among its district offices in reporting such loans.

--Makes no distinction between franchises and other small businesses in making loans and developing loan eligibility size standards.

ADEQUACY OF AND COMPLIANCE WITH FRANCHISE LOAN GUIDELINES

Generally, SBA procedures and regulations for franchise loans are adequate, in our view, to ensure reasonable repayment of the loans. SBA, however, does not comply fully with its procedures and regulations, which may contribute to the number of loans that default and have to be charged off.

We were asked to answer the following questions concerning the franchise loan guidelines.

"* * * what are the SBA guidelines for franchise loans?"

"Are they adequate?"

"Are SBA Standard Operating Procedures for granting 7(a) loans to franchisees adequate to ensure reasonable repayment of the loans?"

"Also, please evaluate SBA's record of compliance with these guidelines."

SBA's procedures for reviewing and approving franchise loans are essentially the same procedures applicable to other 7(a) loans, with only a few additional procedures specifically applicable to franchise loans. About 89 percent of SBA franchise loans have been made under its 7(a) program.

The Small Business Act, as amended, provides that all loans made under section 7(a) shall be of such sound value or so secured that loan repayment is reasonably assured. In determining eligibility, sound value, and security of loan applicants, including franchisee applicants, SBA's operating procedures stipulate the following:

1. SBA cannot extend credit to loan applicants if reasonable financial aid is available elsewhere.

   a. Applicants must submit proof of refusal from their bank of account showing the date of refusal, amount and terms requested, and reason for declining the loan.

   b. SBA credit cannot be extended if reasonable financial aid is available from sources other than banks.

2. A copy of the franchise agreement, where applicable, should be obtained to determine:

   a. The extent to which the franchisor is affiliated with the franchisee.

   b. The right of the franchisee to profit from his effort commensurate with ownership of a business.

   c. The impact that the franchise provisions will have upon the franchisee's ability to repay the loan.

3. Field offices should obtain commercial credit reports on loan applicants to determine the applicant's credit standing. Credit reports should also be obtained

for franchisors whenever their financial responsibility and reputations are unknown.

4. The loan should be secured by collateral of a type, amount, and value which will assure repayment of the loan. Appraisals are required where real or personal property is pledged as loan security; however, "independent" property appraisals are not required when acceptable appraisals are furnished by the borrower or the bank.

5. Before any loan funds are disbursed, the franchisor is required to give written approval of the franchisee's business plan. This ensures SBA that the franchisor is aware of the financial arrangements the franchisee has agreed to as a condition of the loan.

6. The ability to repay a loan from the cash flow of the business (giving due regard to fixed asset replacement needs during the life of the loan) is the most important consideration in the loanmaking process.

We found that SBA is not complying fully with these procedures. It is not making adequate examinations of prospective borrowers' financial conditions and management before approving the loans, nor is it providing borrowers enough assistance after the loans are made. Following are examples of SBA's noncompliance with its procedures.

--Twenty defaulted franchise loans in the district offices visited appeared to have insufficient collateral to recover the unpaid loan balances. Recoveries of only about $584,000 were made although the outstanding balance on these loans totaled about $1,351,000. (See p. 10.)

--Only 7 of the 92 loan files reviewed contained all the data required concerning proof of loan refusal. (See p. 24.)

--Only 2 of the 92 loan files contained credit reports on franchisors. (See p. 29.)

--Twenty-six loan files did not contain credit reports on franchisees. (See p. 30.)

--Sixty-two of the 92 loan files reviewed did not have franchise agreements. (See p. 30.)

--Management evaluations were not made during loan application processing for 67 of the 92 loan files reviewed. (See p. 48.)

Also, only 9 of the 33 franchisees contacted in the 10 district offices visited said they had attempted to obtain financing from the franchisor. All were unsuccessful. (See p. 27.)

SBA MAY NOT BE FUNCTIONING AS A LENDER OF LAST RESORT

Although SBA is required by law to determine that it is functioning as a lender of last resort in making loans, its franchisee loan files generally did not contain adequate documentation proving loan refusal by banks and other potential sources of funds. As a result, SBA may be making loans to franchisees who could obtain them from non-Federal sources. Furthermore, problems for which prospective borrowers might need assistance may not be evident because loan officers are not informed of the reasons banks and other potential lenders declined to make a loan.

We were asked to answer the following specific questions concerning SBA's legal requirement to be a lender of last resort.

"Is SBA indeed acting as a lender of last resort in granting loans to franchisees?"

"Do SBA's files on franchise loans include proof of loan refusal from private lenders or others including the franchisor?"

"Do those refusals include dates, amounts, terms and proof of refusal?"

Proof of bank refusal not adequate

The Small Business Act, as amended, provides that SBA shall not make or guarantee loans under the 7(a) program if financial assistance is available on reasonable terms from non-Federal sources.

SBA regulations (13 C.F.R. 122.2) provide that:

"It is the intent of Congress that Government assistance should be extended only after all other possible avenues for solving a small firm's financial problems have been explored.

"In response to requests for financial assistance, consideration is given to * * * possible means of obtaining credit on reasonable terms from banks, other private financing sources, or from utilization of the personal credit or resources of the applicant's owners or management; * * *."

Also, the regulations provide that, if unable to obtain a private loan from a bank or other source, the applicant should ascertain whether a financial institution will make the loan if SBA agrees to purchase an immediate participation, or if SBA agrees to guarantee a portion of the bank loan. In such cases, the applicant should furnish the names of financial institutions to which he has applied for financial assistance; the reason he was unable to obtain the financing applied for; and whether the financial institution, if unable to make the loan itself, would make the loan in participation with SBA. Such information should have written confirmation from the lending institution and should be submitted to SBA with the application. In addition, the regulations provide that this proof of refusal must contain the date, amount, and terms requested, as well as the reasons for not granting the desired credit.

These regulations further state, as a basic principle governing applications for financial assistance, that "Applications for financial assistance may be considered only when there is evidence that the desired credit is not otherwise available on reasonable terms." Financial assistance as defined in these regulations includes "direct loans made by SBA, immediate participation loans, and guaranteed loans [underscoring added]." Therefore, SBA is required to obtain proof of refusal on all loans to meet its legal requirement to be a lender of last resort.

For guaranteed and participating loans, however, SBA only requires lenders to certify on the loan application that without SBA's participation, the lender will not make a loan to the small business applicant. The application does not require the lender to submit any information concerning the terms and conditions of the loans the prospective borrower requested or the lender's reason for denying the loan. SBA is therefore unable to determine, as required, whether the loan terms and conditions requested were reasonable or why the lender denied the loan.

An SBA headquarters attorney told us that SBA's loan application does not require the lender to submit specific information on the loan requested because SBA had been trying to keep loan processing as simple as possible and avoid

complaints about too much Government "red tape." Also, this official said that the bank, by stating that it will not make a loan without SBA's participation, does not relieve SBA personnel of the responsibility for determining whether funds from sources other than the bank are available.

Our 1976 report pointed out that one reason SBA's loan servicing efforts had suffered was that SBA was not requiring participating banks to indicate their reasons for declining loans without an SBA guarantee. District officials told us at that time that they considered a bank's willingness to participate in the guaranteed loan program as evidence of direct loan refusal and that the bank application for an SBA guarantee was sufficient evidence of refusal to make a direct loan. A 1979 report following up recommendations made in our 1976 report on the 7(a) program points out that SBA had not made any substantial improvements.

In commenting on our 1976 report, SBA said that it believed it had ample legal justification for requiring applicants to obtain the reasons for refusal from banks but had to weigh this against the additional paperwork and legwork on the part of small business applicants and against the possible harmful effect that such a requirement would have on SBA's bank relations.

An SBA October 25, 1979, letter commenting on our followup report states that:

> "Concerning requiring loan applicants to obtain the reasons why banks have refused to make loans to them, we believe our present requirements are adequate. Banks are required by the Equal Credit Opportunity Act to provide each applicant who is denied credit the reasons for such action if the applicant so requests. In the case of direct loans, we require bank turn down letters. In the case of guaranty loans, we require the applicant's bank of account to certify that the financial assistance is not otherwise available on reasonable terms and that they would not make the loan without SBA's guaranty.
>
> "The Agency's current strategy is to place greater reliance on the participating lenders to make and service loans.
>
> "We believe the present requirements are adequate and we do not intend to pursue any changes. To adopt GAO's recommendation would be damaging to

the Bank Certification Program because it would imply a bad faith on our part in their certification."

(The Bank Certification Program is a pilot program begun in February 1979 in which SBA-certified banks are given responsibility for determining the credit-worthiness of prospective borrowers. Additional authorities are expected to be delegated to the certified banks when applicable legislation is passed).

Our review of franchise loans showed that only 23 of the 92 loan files reviewed contained written letters of loan refusal from lending institutions. Sixteen of the 23 letters were incomplete as to the date, amount and terms of the loan requested, and the reasons for refusal. Only 7 of the 92 were therefore adequately documented in accordance with Federal regulations.

District officials believe that SBA generally acts as a lender of last resort on franchise loans. However, we obtained mixed reactions concerning obtaining proof of refusal from banks. For example, San Francisco district officials told us that they obtain bank letters of refusal containing the required financing data. Our review of six loan files in the district showed that these procedures were not being followed. Officials from other districts visited, including five districts in the Northeast, did not believe it necessary to obtain bank letters of refusal on SBA-guaranteed loans. Furthermore, where bank letters of refusal were obtained, district officials said they did not always require that such letters contain the amount and terms of the loan and the bank's reason for refusal. One district official did not believe that such data was necessary to comply with the intent of the law, and an official from another district did not believe that proof was needed even for direct loans.

District officials generally concurred that statements contained on the applications for SBA-guaranteed loans were considered sufficient evidence that banks had refused to finance the loan and the loan was being submitted to SBA as a lender of last resort. Some said that banks generally do not provide financial assistance similar to that which SBA provides because:

--Most banks are usually adverse to extending long-term credit to small businesses.

--Small banks usually have low credit limits.

--Banks are more concerned than SBA about loan collateral.

San Francisco regional officials agreed with district officials that the bank, by stating on the loan application that it would not make a loan without SBA participation, had provided sufficient proof of refusal. They believed that an alternative means of obtaining this legally required data, such as through a short SBA form letter requiring the date, amount and loan terms applied for, and the reasons for bank refusal, would only jeopardize SBA's relationship with participating banks. Also, they said that SBA is moving toward giving banks more authority to make loan credit decisions, with SBA's review to be limited to eligibility determinations.

Franchisors are not considered as potential loan sources

SBA does not consider franchisors as potential loan sources for franchisees and, as a result, may be providing financial assistance to borrowers that could have obtained such assistance from non-Federal sources.

We were asked to answer the following questions concerning franchisors' financial capabilities and lending practices.

"Does SBA consider whether the franchisor is financially capable of financing the franchisee? If not, why not?"

"Is it customary for such franchisors to lend money to their franchisees, and, if so, under what circumstances?"

"If it is not customary, could it be?"

" * * * where there are franchisors which have SBA assisted franchisees, what percentage of all franchisees obtain financing from these franchisors rather than from the SBA?"

Neither the law nor the Code of Federal Regulations specifically states that franchisors must be considered as potential financing sources for franchisees. Section 7(a) of the Small Business Act, as amended, provides that no financial assistance can be extended unless the assistance applied for is not otherwise available on reasonable terms from non-Federal sources. SBA regulations (13 C.F.R. 120.2)

provide that before SBA can make a loan, it must ensure that financial assistance is not otherwise available on reasonable terms through

--the public offering or private placing of securities of the applicant;

--the disposal of assets not required by the applicant in the conduct of his or her existing business or not reasonably necessary to its potential growth;

--utilization of the personal credit or resources of the owner, partners, management, or principal shareholders of the applicant, without undue hardship; and

--other Government financing.

Also, proof of refusal of financial assistance from lending institutions is required before SBA can provide such assistance, as discussed previously in this report.

Only 1 of the 92 loan files that we reviewed disclosed that a franchisor had made a loan to a franchisee. SBA does not consider whether franchisors are financially capable of financing franchisees, according to some SBA officials, because they believe franchisors generally have no funds for or expertise in this type of financing. Banks are considered to be the primary franchisee funding source. Some franchisors lend money or extend credit to franchisees on a short-term basis to finance inventory; however, franchisors generally do not finance franchisee business operations, according to these officials.

SBA San Francisco regional officials advised us that, although SBA has the authority to request loan guarantees from franchisors, the authority is seldom used. Since SBA's program mission is to help the small businessman, these officials believed it would not be beneficial to the program to require franchisor guarantees.

SBA headquarters officials said that franchisors are not considered to be potential sources of franchisee loans simply because franchisors are not lenders. SBA does not have an official policy on franchisors as an alternate source of credit. An SBA attorney said that, in his opinion, franchisors were alternative sources of financing and should be considered as such to reduce the amount of, or eliminate the need for, an SBA loan. He felt that the regulations required SBA to explore all alternatives, including financing by franchisors, for eliminating the need for an SBA loan.

With regard to the question of whether it is customary for franchisors to lend money to their franchisees, most of the SBA district officials we interviewed stated that it was not customary. However, auto dealers may obtain some financing from the franchisors' subsidiary credit corporations. In addition, a franchisor may sometimes provide short-term credit when a franchisee is a good customer and is considered a good risk. Of 33 franchisees we interviewed, 9 had requested loans from the franchisors. All were refused.

SBA district officials had doubts about the feasibility of franchisors lending to franchisees because (1) franchisee eligibility and independence would be questioned and (2) franchisors are not in business to make and service loans.

An official from the International Franchise Association, a trade association representing about 380 franchisors, said that franchisors do not make loans primarily because they do not have the necessary capital. In responding to our questionnaire, however, only 25 of the 69 franchisors that do not make direct loans to their franchisees said that lack of financial resources was to a "very large extent" or "substantial extent" a primary reason they were not doing so. This small number could be due to the fact that these 69 franchisors are among the largest in terms of numbers of SBA direct or guaranteed loans obtained by their franchisees and include some of the larger corporations in the Nation.

For those franchisors who have SBA-assisted franchisees, SBA district officials either did not know or considered minimal the percentage of all franchisees who obtain financing from the franchisors rather than from SBA. Only 6 of 75 franchisors (8 percent) responding to our questionnaire said that they made direct loans to franchisees. These 75 franchisors were among the largest in terms of the number of SBA loans obtained by their franchisees. Also, only 9 of 74 franchisors (12.2 percent) said that they guarantee, fully or partially, repayment of loans made to new franchises.

In view of the statutory requirement that SBA be a lender of last resort, and the numerous possible sources of financial assistance required to be exhausted outside SBA, it appears SBA should consider franchisors as another source of franchisee financing. This is especially desirable in those cases in which some of the major automobile manufacturers have established subsidiary credit corporations that make loans to their dealers. These dealers comprise a significant portion of SBA franchisee borrowers. Three of the top four franchisors whose franchisees have received SBA loans are three of the major automobile manufacturers. As

of April 1979 dealers from these three companies had received about 1,800 SBA loans totaling about $162 million. If SBA required these dealers to seek financial assistance from the credit corporations before becoming eligible for SBA assistance, it could possibly reduce its loan volume and help ensure that it was not providing financial assistance to borrowers able to obtain such assistance from non-Federal sources.

MARKETING STUDIES AND CREDIT ANALYSES NOT ALWAYS MADE AND FRANCHISE AGREEMENTS NOT OBTAINED

SBA does not require franchisors to submit marketing studies as part of franchise loan applications, nor does SBA perform any national or regional marketing studies or credit analyses of the franchisors involved with loan applications. Also, SBA does not always obtain credit reports on franchisees or copies of franchise agreements to review the contract terms and financial requirements levied on the borrower. These practices result in increased risk of loss for SBA and may have contributed to losses it has already incurred on franchise loans. Also, by not obtaining franchise agreements, SBA does not know whether the borrower is even eligible for a loan, in accordance with its operating procedures, because it cannot determine (1) the extent of affiliation with the franchisor or (2) the borrower's right to profit or loss commensurate with ownership. In addition, SBA cannot determine whether provisions in the agreement affect the borrower's repayment ability.

We were asked to answer the following questions concerning these matters.

> "* * * before approval of a 7(a) loan, have marketing studies been required by SBA and, if so, are these adequately considered by the SBA loan specialists?"
>
> "Prior to the approval of a loan, does SBA perform on a national or regional basis marketing studies or credit analyses of franchisors, and also, does the SBA review the contract terms, including the franchisor's financial requirements? If not, why not? And what recommendations would GAO have to remedy this situation?"

SBA's operating procedures provide that feasibility reports, marketing surveys, and similar economic studies be prepared when district officials determine they are necessary in loans involving building construction and

purchase or construction of machinery and equipment with loan proceeds. Such studies are to be prepared at the expense of the applicant. The procedures also provide that a franchise agreement is to be reviewed to evaluate the impact that its provisions will have on repayment ability. In addition to reviewing the franchise agreement, a credit report is to be obtained on the franchisor whenever its financial responsibility and reputation are unknown.

Regional officials stated that SBA does not perform marketing studies and credit analyses on a national or regional basis. Also, SBA district officials were not aware of a requirement for marketing studies as part of the loan application; as a result, 9 of the 10 district offices we visited did not require that marketing studies be done before approving a 7(a) loan. Officials of two of the nine district offices, however, said that a few marketing studies are performed. For example, they said that (1) large franchisors occasionally provide some type of study and (2) SBA management assistance staff contracts with consultants for marketing studies of smaller franchises. In the western district offices visited, however, we were told that SBA generally relies on the franchisors or franchisees to make such studies but these were often not available to SBA. Also, we were told that SBA does not have enough time to either perform marketing studies itself or review any that are submitted to it. However, several former franchisees told us that poor location selected by franchisors was a major reason their businesses failed.

District officials also advised us that SBA does not perform any national or regional marketing studies or credit analyses of franchisors. Reasons given for not making such studies were that (1) SBA did not require them and (2) district staff would not have time to analyze them if they were made. SBA officials said that SBA has no requirement for performing financial analyses of franchisors and, although they occasionally request credit reports on franchisors, they generally rely on the franchisors' reputations. In addition, the loan officers obtain information on franchisors by reading various financial periodicals.

Our review of 92 loan files in 10 SBA districts disclosed that credit information on franchisors was obtained in only two instances. Had financial information on franchisors been obtained, SBA could have possibly reduced its risk of loss. For example, SBA made a $30,000 loan to an auto tuneup franchisee, which was subsequently written off. SBA had made loans to other franchisees of the franchisor for several years. In less than a year from the time the loan funds were

disbursed, SBA had information that the franchisor was having financial difficulty. The franchisor was no longer in business at the time of our review.

In addition to not always containing credit reports on franchisors, 26 of the 92 loan files reviewed did not contain credit reports on the franchisee borrowers. Without these credit reports SBA may not be able to determine the borrowers' credit standing, thereby increasing its risk of loss.

With regard to franchise agreements, some SBA officials said that they generally obtained copies of such agreements and reviewed them. Officials from other district offices said they reviewed the contract terms, including the franchisor's financial requirements, whenever prospective franchisees provided copies of franchise agreements. The review included a determination of franchisee eligibility and the restrictions and amount of control exerted by the franchisor.

Procedures for reviewing franchise agreements varied among the districts visited. For example, the San Francisco district told us that its legal counsel reviewed the franchise agreements. A Phoenix district official said that his office relied on the banks to analyze the terms of the agreements. Des Moines district officials said they reviewed the franchisor's contract terms. We noted, however, that the Des Moines district had obtained a franchise agreement for only 1 of the 11 loans reviewed.

Our review of 92 loan files in 10 district offices showed that 30 files included franchise agreements. Forty of the 92 files reviewed were defaulted loans; 30 of these 40 loan files did not contain franchise agreements. Although we did not determine whether SBA's failure to obtain franchise agreements had an adverse impact on the franchisees' ability to repay their loans, we believe that these agreements could have had a significant impact on the success of the businesses.

For example, an automobile parts franchisee who went out of business said that the franchise agreement had an adverse impact on his ability to repay the SBA loan because (1) the franchisor insisted on the subordination of the collateral given to SBA for the loan, (2) the credit line from the franchisor was not as large as the franchisor originally offered, (3) the franchisee was not allowed to seek credit from any other financial institution, and (4) all the franchisee's assets were pledged to the franchisor.

One SBA regional director recognizes that the terms of a franchise agreement can change and agrees that a separate

franchise agreement should be obtained with each loan application. This official believes that it is necessary to review individual agreements to ascertain whether there is any franchisor-franchisee affiliation and to determine the extent of the financial requirements placed on the franchisee.

A published digest of decisions of SBA's Size Appeals Board shows the importance of reviewing franchise agreements; cases are included in which the board ruled, after reviewing franchise agreements, that prospective franchisees were not eligible SBA borrowers. For example,

> "The Board held that franchise provisions relating to the payment of fees to franchisor on the basis of gross receipts (5 %) and gross profits (33-1/3 %) denied franchisee the right to profit and that franchisor had the power to control the franchisee within the meaning of the regulations."

In another case,

> "The contractual arrangement under which the company * * * proposed to operate * * * was held not to be a franchise agreement within the meaning of the regulations. The Board gave effect to the major provisions of the agreement as they related to the question of control and held that the company in question did not have the power to make those major business decisions it should and ought to make as an independently owned and operated concern. * * * Affiliation was found."

We interviewed 11 franchisees in the Northeast who had defaulted on their SBA loans. Five of them felt that the franchise agreement had hindered their ability to repay the loans. Four of the five also felt that the franchise agreement was too restrictive. Some of the reasons given were:

--The franchisee could buy only from the franchisor.

--The franchisee was restricted as to selling price.

--The franchisee was forced to use franchisor credit.

--The franchisee was forced to assume the liabilities of the previous franchisee.

Two of six franchisees interviewed who had SBA loans outstanding at the time of our review felt that the franchise agreements were too restrictive and were hindering their

ability to repay their SBA loans. One franchisee said that the requirement to pay cash upon delivery created a hardship. The other franchisee said that the payments to the franchisor were excessive.

NEED FOR UNIFORMITY IN CLASSIFYING FRANCHISE LOANS

Our review disclosed that SBA has not defined a franchise. SBA's Standard Operating Procedures contain numerical codes for those companies SBA considers to be franchisors; district offices use the codes to classify loan applicants. However, each district office independently determines which loan applicants it will include under these codes. As a result, SBA cannot properly apply legal requirements and Standard Operating Procedures to all franchise loans because of this lack of uniformity. Furthermore, lack of a definition results in SBA inaccurately reporting franchise loans made.

We found that the SBA San Francisco, Phoenix, Providence, Hartford, Augusta, and New York district offices do not consider gasoline service stations to be franchises. Also, the San Francisco and Phoenix district offices do not consider automobile dealers to be franchises. Conversely, the other four district offices visited do consider gasoline service stations and automobile dealers to be franchises. In addition to excluding gasoline stations, the Phoenix district office did not classify all Western Auto and True Value Hardware stores as franchises.

Also, our review disclosed that loans to franchisees of some franchisors were being accounted for under several names even though only one franchisor was involved. For example, SBA had three separate franchisor identification codes for classifying loans made to franchisees of one franchisor. SBA operating procedures contain franchisor codes for both MAACO Enterprises and MAACO Auto Painting Center. Many loans to franchisees of this franchisor are listed under yet another code. In addition, many loans classified as franchise loans should not have been, in our opinion, because either (1) the company is not engaged in franchising (such as General Electric--36 loans totaling $1.6 million) or (2) the SBA "franchisor" is not in fact a franchisor but an association (such as Best Western Motels--27 loans totaling $3.9 million).

These practices result not only in inaccurate reports on franchise loans but also in improper review and analysis. For example, one of the legal eligibility requirements for an SBA franchise loan is independent ownership and operation of the business. Compliance with this requirement was not

ensured for franchise businesses in many cases because district offices did not obtain and review the franchise agreements. These agreements are crucial in determining whether the franchisee (1) is affiliated with the franchisor, which would make him ineligible, and (2) has the right to profit and bears the risk of loss from the business commensurate with ownership.

Also, by improperly classifying franchise loans, SBA may be depriving its loan officers of information which could result in better loan decisions. For example, a loan officer may make a more careful analysis of a borrower if he knows that other franchisees of the franchisor in question have had a high default rate on SBA loans. His caution may, therefore, result in reducing SBA loan losses.

SBA regional office officials in San Francisco and Boston agreed that the agency needs a definition of a franchise. While they did not say precisely what they thought the definition should be, the San Francisco officials believed it should include any business operating under a license, franchise, or membership agreement which allows it to use another business' name. This is similar to the Federal Trade Commission definition of a franchise.

> "A system used by a company (franchisor) which grants to others (franchisees) the right and license (franchise) to market a product or service and engage in a business developed by it under franchisor's trade names, trademarks, service marks, know-how and method of doing business."

SBA MAKES NO DISTINCTION BETWEEN FRANCHISES AND OTHER SMALL BUSINESSES

SBA does not consider the differences between franchises and "independent" businesses in developing its size standards. Also, in accepting or declining loan applications, SBA apparently gives no priority to franchisees of large franchisors over those of small franchisors. Each franchise loan application is considered on its merits without regard to the size of the franchisor.

We were asked the following questions concerning these matters.

> "In developing a size standard, does SBA consider the differences between franchises and independent businesses in terms of (1) competitive strength and (2) the size of the franchisor?"

"Does SBA consider the financial condition of the franchisor?"

"How many prospective franchisees of small franchisors have been denied loans, because the available funds had already been approved or disbursed to prospective franchisees of large franchisors?"

Part 121 of SBA's regulations (13 C.F.R. 121) establishes the criteria, standards, and procedures for determining which concerns are considered small and therefore eligible for SBA assistance. The size standards contained in the regulations are generally industry by industry, in line with Standard Industrial Classification codes, and expressed in terms of employment or annual sales receipts. The regulations do not require that the size standard determination specifically consider the competitive advantage, size, or financial condition of franchisors.

SBA considers a business to be small if it (1) is independently owned and operated, (2) is not dominant in its field, and (3) meets the SBA employment or sales size standards. These general criteria apply to franchise operations as well as other small businesses. Other eligibility criteria may also have to be met, depending on the type of assistance requested. SBA's primary concern in determining a franchise's eligibility for a 7(a) loan is whether the franchise is controlled by the franchisor to the extent that it is affiliated with the franchisor or whether the franchisee has the right to profit, commensurate with ownership, and bears the risk of loss or failure. If SBA determines that the franchisee has the right to profit, the amount of control exerted on the franchisee is secondary.

SBA's operating procedures provide that the franchise agreement, financial statements, and other documents should be reviewed to assure that the franchisee applicant meets SBA-loan eligibility criteria--that is, that the franchisee has the right to profit and loss commensurate with ownership, rather than operating under an employment relationship.

District officials advised us they generally make no distinction between franchises and other small businesses. San Francisco district officials said that, although the size and strength of franchisors do give franchisees some competitive advantage over other small businesses, the size of the franchisor would be considered only if the affiliation between the franchisor and franchisee were so close as to make the entire franchise operation exceed SBA's size

standard. Almost all district and regional officials we contacted agreed that franchisees enjoyed a competitive advantage over other small businesses through such things as the name, advertising, and management assistance provided by the franchisors. However, they generally did not believe these competitive advantages warranted any change in SBA's loan policy.

District and regional office reactions were mixed as to the extent of consideration given to the franchisor's financial condition. Los Angeles and Phoenix district officials said that they gave no consideration to the franchisor's financial condition. A Los Angeles district official believed that such consideration might show favoritism. On the other hand, Des Moines and San Francisco district officials said that they do review franchisors' financial conditions--this review was limited in the San Francisco district to new, unknown franchisors. All the district offices visited in the Northeast agreed that the financial condition of the franchisor should be considered.

An SBA Boston regional office official, however, felt that the franchisor's financial condition should not be considered when making loans to prospective franchisees, since SBA is dealing with the small businessman and not the parent organization. A New York regional office official felt that the franchisor's financial condition is a factor which must be weighed on a case-by-case basis.

SBA plans to award a contract in the near future to study (1) the relationship between the franchisor and the franchisee and its effect on the independence of the franchisee, (2) the effect of Federal and State laws on franchisors and franchisees, and (3) the extent to which SBA is providing needed services to the franchising sector. Concerning SBA services, the study will focus on matters such as the extent of SBA financial assistance to franchising; problems associated with obtaining SBA financing; extent to which SBA management assistance is provided to franchisees and prospective franchisees; and how SBA can more effectively fulfill its obligation to the franchising sector by aiding, counseling, assisting, and protecting the interests of small, independent franchisees and franchisors.

Information was not available to enable us to specifically determine whether prospective franchisees of small franchisors had been denied loans because the available funds were already approved for prospective franchisees of large franchisors. However, we noted that the top 25 franchisors' franchisees received about 6,500 (totaling

$449.8 million) of the 16,379 loans (totaling about $1 billion) that SBA had made to franchisees or guaranteed through April 1979, as shown on the following page.

Officials in four of six district offices visited in the Northeast stated that there was no way of knowing how many prospective franchisees of small franchisors have been denied loans because the available funds had already been approved or disbursed to prospective franchisees of large franchisors. No statistics were kept as to how many franchisees of small franchisors had been denied loans. A New York district office official said that loans were made on a first-come, first-served basis; each loan was judged on its own merits; and no loans had been denied to franchisees of small franchisors because of the reason above. Another district official said that it would be discriminatory to deny a loan to an eligible business of a small franchisor and then approve a loan to an eligible business of a large franchisor.

Officials in the western district offices visited generally did not establish loan priorities or allocate funds by type (franchise versus nonfranchise) or kind of business. Applications for small businesses were usually processed as they were received, and loans were approved based on the applicant's ability to repay them. One of these district officials said there might be some discrimination when direct loan funds run short; however, such preferential treatment would be based on the size of the loan. SBA does not generally deny any guaranteed loan requests due to lack of funds, according to these officials.

In the western district offices visited, we analyzed 23 franchise loan applications that were declined during fiscal years 1977 and 1978 to determine the reasons for declining the loans. In each instance, at least two reasons were given for declining the loans. The most frequently used reasons were:

--Lack of reasonable assurance of the applicant's ability to repay the loan and other obligations from business earnings.

--A disproportion between debts and tangible net worth of the business, both before and after the loan.

--Collateral, considered along with other credit factors, was deemed insufficient to protect the interest of the Government.

Top 25 Franchisors According to the Number of SBA Loans Their Franchisees Had Received as of April 30, 1979

	Number of loans	Amount disbursed (millions)
General Motors Corp.	792	$78.2
Ford Motor Co.	662	56.3
Western Auto	395	14.8
Chrysler Motor Corp.	384	27.7
Standard Oil	325	16.6
Coast to Coast Stores	322	16.7
Ben Franklin Stores	279	22.3
Kampgrounds of America	270	20.3
Gamble's Stores	270	11.2
Dairy Queen	256	13.5
Maaco	255	10.0
Deere and Company	240	23.8
McDonald's Corporation	225	29.6
International Harvester Company	219	22.2
Texaco, Inc.	202	6.9
Baskin-Robbins	192	6.5
A & W International	190	15.7
Aamco Transmissions	146	4.9
Independent Groceries of America	145	11.9
Mobil Oil	140	3.5
True Value Hardware	135	11.6
Jack and Jill (Nash-Finch)	130	7.7
White Auto Stores, Inc.	120	3.8
Radio Shack Corp.	115	3.2
Super Valu Stores	111	10.9
Total	6,520	$449.8

To the extent information was available in the six district offices visited in the Northeast, we determined that for fiscal years 1977 and 1978:

--The Concord and Providence district offices did not decline any franchise loan applications.

--The Augusta, Boston, and Hartford district offices declined a total of 21 franchise loan applications, 15 of which were franchisees of larger franchisors such as General Motors and the Ford Motor Company.

--The New York district office did not have information on franchise loans for this period.

Some of the reasons for declining the 21 loan applications mentioned above were:

--Lack of reasonable assurance of ability to repay loans.

--Value of collateral deemed insufficient.

--Disproportion of debt to net worth.

--Lack of satisfactory evidence that funds were not obtainable through personal credit of the partners.

--Gross disproportion between owner's actual investment and loan requested.

--Inadequate working capital available after the loan was made.

A comparison of the percentages of all franchise loans declined with all other 7(a) loans for fiscal years 1977 and 1978 in the districts we visited showed that a smaller percentage of franchise loans was declined. For example, for the four western district offices visited, the number of franchise loans declined, as a percent of those approved in 1977 and 1978, was about 9 and 11 percent, respectively, based on the limited records available. In contrast, the percent of other 7(a) loans declined in these district offices was about 19 percent in 1977 and 12 percent in 1978.

An SBA headquarters division director told us that SBA had no statistics on the number of loan applications denied or the reason for the denials. A headquarters senior field management officer did say that SBA regional offices are allocated basically whatever guaranteed loan authority they feel they can use because SBA receives more than it can use.

He said that for the last 10 years, SBA had not used all the guaranteed loan authority provided. Also, an SBA headquarters budget analyst told us that a comparison of guaranteed authority received and used over the past 10 fiscal years would show that the entire amount of authority was not used in most cases.

Our analysis of SBA 7(a) program guaranteed loan authority received and used in the past 9 fiscal years showed that the amount received was not used in 8 of the years. About $718 million of the $3.3 billion of authority received in fiscal year 1979 was not used. It therefore appears that SBA is not refusing loans to franchisees of small franchisors because it has used up its loan authority in guaranteeing loans to franchisees of the larger franchisors.

CONCLUSIONS

SBA is making 7(a) loans to franchisees without obtaining adequate assurance that financing is not reasonably available from banks and non-Federal sources. Although SBA contends that submission of loan applications is sufficient to meet the intent of the law, the applications do not show why banks declined to make loans themselves or, in most cases, the date, terms, and amount of the rejected loan. We believe that proof of refusal and other loan data would be valuable to SBA in determining potential financial and management problems which the franchisee applicant may experience.

SBA does not consider whether franchisors are financially capable of financing franchises, mainly because SBA does not believe that franchisors are lenders. However, in view of (1) our finding that many franchisors said they have funds and some already loan or guarantee loans, (2) the extensive list of possible sources of financial assistance that an applicant is required to refer to before applying for an SBA loan, and (3) the requirement that SBA be a lender of last resort, we question the practice of not considering franchisors as potential lenders.

SBA is not requiring marketing studies and credit analyses of franchisors and, in some cases, of franchisees to be provided with the loan application. Also, SBA is not always obtaining copies of franchise agreements in order to review the contract terms and financial requirements levied on borrowers. We believe that these practices result in increased risk of loss to SBA and may have contributed to losses already incurred.

Financial and credit analyses of franchisors are needed for SBA to determine whether franchisors are financially capable of (1) making loans to franchisees, (2) guaranteeing SBA direct loans or sharing bank loan guarantees with SBA, as recommended in chapter 2, and (3) staying in business until their franchisees' loans are repaid. To avoid duplication, these analyses should be done centrally and the results disseminated to all SBA offices.

To determine the criteria to be applied to a small business loan, SBA needs to define a franchise so that specific criteria may be applied in evaluating franchise loan applications. Once an adequate definition is developed, criteria must be established requiring that SBA district offices consistently apply the definition.

RECOMMENDATIONS

We recommend that the Administrator, SBA, take the following actions to improve SBA franchise loan practices:

--Require district offices to obtain for all loans proof of bank refusal to make loans to franchisees, including the date, amount and terms requested, and the reason for refusal, as required by Federal regulations. Alternative methods of obtaining this information might be to (1) revise the loan application to include it as part of the required information thereon or (2) develop a new, short form to be submitted with the loan application.

--Revise SBA regulations to require that SBA not make or guarantee franchise loans if the franchisor can provide assistance to franchisees on reasonable terms.

--Require that the headquarters office make financial analyses of franchisors, particularly those whose franchisees have received over 100 loans, and advise the district offices of the results for their use in obtaining franchisor guarantees of SBA direct loans and sharing of bank-loan guarantees with SBA. Also, these analyses will help ensure that loans are not made to franchisees whose franchisors are not financially sound.

--Emphasize that district offices make or otherwise obtain credit analyses of all franchisees, as the Standard Operating Procedures require.

--Require district offices to obtain and review franchise agreements in all cases to ensure that provisions in the agreements do not make prospective franchisees ineligible for loans or unduly restrict their repayment abilities.

--Revise SBA Standard Operating Procedures to define a franchise so that (1) inconsistencies existing in the district offices in reporting franchise loans will be eliminated, (2) loan officers will not be deprived of information which could result in better loan decisions and reduced risk of loss, and (3) chances of improper review and analysis of loan applications will be reduced.

AGENCY COMMENTS

SBA officials generally disagreed with the above recommendations.

Concerning the first recommendation, the officials believed that banks, by stating on loan applications that they would not make loans without an SBA guarantee, had submitted sufficient proof of refusal. Also, in its October 1979 reply to our followup report, SBA stated that its present requirements on this matter were adequate and that it did not intend to make any changes because such changes would be damaging to the Bank Certification Program. (See pp. 23 and 24.)

As pointed out in this report, however, the law requires that SBA act as a lender of last resort, and Federal regulations provide that proof of loan refusal by banks and other non-Federal sources must contain the date, amount, and terms the borrower requested from the lender and the reasons the lender refused to make the loan. SBA is not now obtaining such proof.

Concerning the second recommendation, SBA officials said that while they agreed that franchisors could perhaps be an alternative source of funds for franchisees, they were aware of problems. These officials said that (1) franchisors were not financing institutions, (2) franchisors did not have funds to make loans, and (3) requiring franchisors to accept loan applications would result in fewer loans to franchisees. Also, they said that if SBA required a letter of loan refusal from franchisors, processing delays and/or imposition of another Government requirement would result.

In responding to our questionnaire, 11 franchisors said they now make direct or other types of loans to franchisees.

For the 5-year period ended December 31, 1978, 16 franchisors said they made about 1,900 loans to franchisees, totaling about $133.5 million. Also, only 23 of 55 franchisors (42 percent) said that lack of funds was a primary reason they do not make direct loans to their franchisees. Most franchisors--47 of 60 responding (78 percent)--said the primary reason for not making these loans was that loans were available elsewhere. Accordingly, SBA should exhaust all possible sources of financing before making or guaranteeing loans. Otherwise, it cannot ensure that it is the lender of last resort, as the law requires.

With regard to our criticism that SBA was not always obtaining credit reports or analyses of prospective franchisees, SBA officials said that for guaranteed loans, participating banks should have been obtaining the analyses. Also, they said that recently required FTC data that franchisors must provide to prospective franchisees, which SBA districts will obtain from the franchisees, will help SBA determine franchisors' credit standings.

SBA procedures require that field offices obtain commercial credit reports on loan applicants to determine their credit standings. In 26 of 92 cases reviewed, this requirement was not met. The FTC-required information on franchisors should help SBA district offices analyze franchisors. However, to minimize its potential losses, SBA should obtain credit analyses of both franchisors and franchisees.

Concerning district offices not obtaining and reviewing franchise agreements in many cases, one of the officials commented that SBA requires district offices to review the agreements and assumes they are doing so even if a copy is not filed. But, as mentioned in this report, our discussions with district officials showed that franchise agreements were not being reviewed in many cases. One SBA regional director agreed, however, that district offices should obtain and review these agreements for each loan application. Also, a district official said his office relied on banks to review franchise agreements. SBA, therefore, is not reviewing these agreements as required.

SBA officials agreed with our recommendation to define a franchise. Also, they said that the information which will result from an analysis of SBA's franchise loan portfolio will be used, among other things, to guide loan officers in judging franchise loan and loan guarantee applications.

CHAPTER 4

FRANCHISEES COULD BE BETTER ASSISTED

Although SBA provides some information, counseling, and management assistance to franchisees, improvement is needed to better assure the success of franchise loans. We found that SBA does not:

--Provide prospective franchisees with information on their franchisors and SBA experience on franchise loans.

--Always provide useful counseling and assistance to borrowers on a timely basis.

Furthermore, many franchisees said that counseling and assistance provided by banks and franchisors were limited.

SBA INFORMATION ON FRANCHISORS NOT PROVIDED TO PROSPECTIVE FRANCHISEES

Although SBA has been making loans to franchisees for many years, it has not distributed any specific information on franchisors or overall experience with franchise loans to district offices for dissemination to loan applicants. SBA district offices have only limited information available to assist franchise loan applicants and themselves in making loan decisions.

We were asked the following questions concerning SBA's practices in providing this information.

> "On November 11, 1971, the FTC [Federal Trade Commission] proposed rules (now becoming effective July 21, 1979), requiring franchisors to disclose certain information to the franchisees, including business records, the contract terms, fees required by those terms, indirect costs, the number and location of failing franchise operations, etc. Although SBA endorsed this rule in 1972, what steps has it taken to provide prospective franchisees who apply for SBA loans with this and other information about franchisors?"

> "Has SBA revealed to prospective franchisees of a company the failure rate of that company's franchisees which have an SBA loan outstanding and the reasons for these failures?"

"Are district and regional offices of the SBA, and their loan specialists, regularly provided with data on the SBA loan history of those franchisees having defaulted on their loans? If not, how could SBA improve its procedures?"

On October 21, 1979, FTC rules went into effect requiring companies offering franchises to provide prospective franchisees with a disclosure document containing information on the franchisors and the franchises. Information required in the disclosure document includes:

--Business, litigation, and bankruptcy history of the franchisor, as well as of its directors and key executives.

--Costs, both initial and recurring, that the franchisee will be required to pay.

--Restrictions placed on the franchisee's conduct of business.

--Termination, cancellation, and renewal provisions of the franchise agreement.

--Statistical information about the number of franchises and their rates of termination.

--Description of any franchisor assistance in financing the purchase of the franchise.

Also, the FTC rule prohibits franchisors from misrepresenting sales income or profits that can be expected from franchise operations. Disclosure statements must be provided to prospective franchisees before any contracts are signed or moneys paid.

SBA had not issued any instructions at the time of our review regarding furnishing franchisee loan applicants with information about franchisor operations. As a result, SBA has not been providing prospective franchisees any specific information on franchisor business operations. District officials, for the most part, were unaware of the FTC rule or SBA's proposed action regarding it. A few of the Northeast district offices visited had copies of the FTC rule, but did not know what to do with it since they had not received any accompanying instructions from SBA regional offices or headquarters.

The information available to SBA loan personnel on franchisors has generally been obtained informally from various

sources. As a result, the type and amount of information made available to franchisees varies from district to district. For example, a Des Moines district official told us that loan personnel always pass along any information on franchisors to applicant franchisees. The Los Angeles district only responds to applicant requests for information about the franchisor. On the other hand, the Phoenix district believes that loan applicants should obtain information about franchisors on their own.

In March 1979 SBA issued a circular which stated that the FTC rule requiring franchisors to prepare and submit to each prospective franchisee a disclosure report on its franchise operations would not only be valuable to prospective franchisees but also useful to SBA's review and approval of loan applications. A revision to SBA's Standard Operating Procedures states that SBA offices should obtain a copy of the FTC-required franchisor report. SBA has not taken any action to provide prospective franchisees with this information or other information about franchisors.

Also, SBA has not provided its field offices with the SBA loan history of those franchisees who defaulted. Although SBA computer data is available on the status of each loan, it has not been consolidated so that an analysis of the loans by franchisor can be made. In addition, SBA has not accumulated any data on the reasons for loan defaults. As a result, loan officers are deprived of this information in trying to protect SBA's interests and are unable to reveal to prospective franchisees the rate of and reasons for failure of a franchisor's franchisees that had SBA loans. District officials said that they do not develop this information and, consequently, cannot provide it to prospective franchisees.

SBA headquarters officials told us that SBA has not analyzed its portfolio of loans to franchisees to determine what types of franchises are receiving loans and the status of these loans. They said that, as a result, no one in SBA knows whether the franchisors are taking advantage of the program by "dumping" marginal operations through SBA or whether certain franchisors are experiencing problems. Also, these officials felt that an analysis to determine the status of SBA franchise loans would be useful to loan officers in reviewing and evaluating franchise loan applications.

Our analysis of 10,531 SBA franchise loans made to franchisees of the major franchisors (108 companies) through April 1979 shows that for two franchisors, over 30 percent of the loans to their franchisees have defaulted. Also, from 15 to 23 percent of the loans for 15 more franchisors have

defaulted. At the time of our review, these loans were either in liquidation or had been charged off. As a group, the oil franchisors' franchisees (dealers) had the worst SBA loan failure rate--about 16 percent.

Both regional and district officials generally agreed that historical data on franchise loan defaults would be helpful and that SBA headquarters would have to be responsible for developing it. A Phoenix district office official believed that such information might influence decisions on, or provide a better basis for, at least 25 percent of SBA's franchise loans. A Des Moines district official was skeptical that the accumulation of the historical loan default data alone would be beneficial without explaining the reasons for defaults.

We believe historical loan default data, as well as the reasons for the defaults, would be beneficial to both prospective franchisees and loan specialists in making loan decisions and would protect SBA's interests by helping to assure loan repayment.

NEED FOR MORE MANAGEMENT ASSISTANCE TO FRANCHISEES

SBA could provide more useful information, counseling, and management assistance to prospective franchisees. Also, SBA has not taken sufficient action to correct the complaint made in our February 1976 report that SBA's failure to offer guidance to borrowers is a major flaw of the 7(a) loan program.

We were asked to answer the following questions concerning SBA assistance provided to prospective franchisees.

> "* * * what information, counseling, and management assistance has SBA provided to prospective franchisees?"
>
> "The February 1976 GAO audit of the 7(a) loan program cited failure to offer guidance as a major flaw of the program; what steps has SBA taken in response to that complaint in the GAO report?"
>
> Title 13 (C.F.R. 129.1) states that:
>
> "The need for assistance in starting, managing, and operating a business is heightened by the number of failures that continue to increase every year in the small business community. It is estimated that managerial deficiencies cause 9 out of 10 business

failures. A major objective of the Small Business Administration is to remedy this situation."

To do so, SBA has established a management assistance program, which is carried out by its district offices.

SBA operating procedures state that it is difficult to assess a loan applicant's management capability without the benefit of a field visit. Procedures in effect prior to August 15, 1977--most of the loans we reviewed were made before this date--state that field visits during the loan approval process were optional on guaranteed loans and could be waived by district officials for direct loans. After loan approval and disbursement, loan specialists were required to visit borrowers with direct loans within 6 months, and borrowers on guaranteed loans within 1 year of loan disbursement. As part of their review activities during initial field visits, loan specialists were required to offer advice to forestall any financial difficulties and to determine whether the borrower needed management assistance.

The procedures in effect since August 15, 1977, state that initial field visits will not be waived and that SBA staff shall schedule field visits within 60 days of initial disbursement, unless postponed. If postponed, the reason must be documented in the loan file and the field visit rescheduled.

With regard to management assistance, the procedures state that some small businessmen are unable to diagnose their business problems. While they often believe that their difficulties can be resolved with a loan, financial assistance is not always the solution. As appropriate, information, counseling, and management assistance are provided to prospective franchisees, principally through the following:

--SBA employees known as "business management specialists" advise small businesses and may call upon the assistance of volunteers and paid consultants.

--Service Corps of Retired Executives is an organization of retired business executives who volunteer their services to help small business owners solve their problems.

--Active Corps of Executives is an organization of volunteers drawn from the ranks of active executives in industry, trade associations, educational institutions, and the professions.

--Small Business Institute is a program which provides faculty-supervised management counseling to small businesses by university graduate and undergraduate students.

--The Call Contract program employs consultants to provide management and technical assistance to socially or economically disadvantaged small business owners.

Review of 92 loan files in the 10 SBA districts visited showed that no field visits were made to 79 of the applicants before loan approval and, although the loans were made before October 1977, SBA loan personnel had not visited 46 of the borrowers at the time of our review in mid-1979--almost 2 years later. In addition, we noted that no management evaluations of franchise loan applicants were made during the loan approval process in 67 instances, and 42 of the franchisees had not been offered or provided SBA counseling and management assistance at the time of our review.

We contacted 33 of the 92 franchisees, including 18 who had gone out of business, to determine (1) the extent of SBA management assistance and guidance they had received, (2) whether SBA could have provided additional assistance, and (3) their suggestions for improving the SBA franchise loan program. Franchisee borrowers generally expressed mixed reactions to the assistance provided. For example:

--An auto transmission franchisee said that SCORE representatives' suggestions were very good, but they did not help his business substantially because of the high sales prices the franchisor required.

--A hardware store franchisee began requesting assistance for financial problems several months after opening his business. Although SBA management assistance officers visited him more than once, he said that no management assistance was received. The franchisee finally took the initiative to visit a SCORE adviser, who told him to declare bankruptcy.

--A university student under an SBI program visited a fast food franchisee who had financial problems. According to the franchisee, the student did not provide him with any new, useful information.

Some of the franchisees who had gone out of business believed that SBA might have helped them more by (1) assisting them when their problems first started or playing a

greater role in resolving the problems, (2) providing management assistance before the loan was made, and (3) getting more involved with the franchise package. Franchisees' suggestions for improving SBA's franchise loan program were:

--Franchise loan applicants should be provided with more information about franchisors, including their financial condition, past and current business operations, and the success/failure rate of their franchisees.

--Franchisees experiencing business problems should be provided more information on assistance available from SBA.

--SBA personnel should maintain more contact with borrowers through additional field visits and by spending more time with borrowers to help resolve problems.

Officials in most districts visited said that franchisees generally received the same types of counseling and management assistance as other 7(a) borrowers. However, they said that, generally, counseling and management assistance were provided only when a need had been identified or borrowers requested it.

Regional officials told us that district offices do not have enough personnel or time to make field visits to all loan applicants and borrowers. They believe such visits should be made on a selective basis when the need has been identified. Similar comments were made regarding management assistance to borrowers, except for one SBA regional official who believed that SBA should not be offering management assistance at all. According to this official, most of the staff involved are not qualified and are completely "out of tune" with what is going on in business.

Other assistance to franchisees

In addition to counseling and management assistance available from SBA, franchisees should be able to obtain assistance from participating banks and franchisors. Although we did not meet with any banks or franchisors, the franchisees we interviewed said that the amount and type of assistance received from their banks and franchisors was often limited.

Of the 14 franchisees contacted who had SBA-guaranteed bank loans, only one apparently received any assistance from

his bank after the loan was made. In only a few instances did bank representatives ever visit the franchisees during the loan period. A few franchisees said that banks might have provided more assistance by:

--Making more frequent visits to determine their business needs.

--Rearranging loan terms to preclude default.

--Providing additional financing.

In one instance, an automobile dealer franchisee with an outstanding loan of $124,000 told us that he may have to close his business because the local banks refused even to talk to him about a loan for operating expenses.

Franchisors generally provide some type of assistance to franchisees. Most franchisees we contacted said that franchisors provided them with some training when they first started their businesses, and a few provided initial advertising and other assistance. Only one franchisee said that he received no help whatsoever from the franchisor when he started his business.

After the businesses began operating, the frequency of visits and the type of assistance provided varied by franchisor. Frequency of visits by franchisor representatives ranged from every few weeks to annually. Some franchisors inspected the franchisees' premises and services periodically, offering suggestions for improvements. Others offered various types of assistance, such as advertising, merchandising and marketing, recordkeeping, and continued training. Some franchisees, however, received little assistance or questioned the value of the assistance they did receive.

FOLLOWUP ON PRIOR GAO REPORTS

In February 1976 we reported that SBA management assistance was being provided to relatively few 7(a) borrowers. The assistance given was often not intensive and reached the borrower only after the loan became delinquent. The report identified a number of causes for the limited assistance. SBA proposed several actions to improve the usefulness of its management assistance program.

SBA, however, has not done enough to improve its management assistance program. Our August 1979 followup report points out that:

"SBA is still not following its own procedures for approving and servicing loans under the 7(a) program. Disregard for the basic steps that have been established to assure that quality loans are approved and that, after approval, there is a better chance of borrower success and loan repayment continues. In the 80 randomly selected loans we reviewed in four district offices, we found that:

--At least part of the loan approval process was inadeq ately performed for 76 loans.

--Servicing was inadequate for 68 loans.

--Management assistance was inadequate for 8 loans.

"Servicing deficiencies included failure to verify the use of proceeds resulting in misuse, failure to follow up through field visits, and failure to receive and analyze borrowers' financial statements to evaluate progress. Management assistance was generally not provided. When provided, it was not always enough to meet the borrower's needs.

"These deficiencies are identical to those discussed in our February 23, 1976, report which was based on our review of 980 loans made in 24 SBA district offices. We made 17 recommendations to the SBA Administrator to correct the problems."

Also, the report points out that SBA has taken steps to identify which borrowers need management assistance. Since October 1978 the field offices have been required to prepare a Summary Management Rating Form for each borrower at the time of loan application. SBA believes the form will establish a systematic method of assessing managerial potential, identifying prospective borrowers who need management assistance, and expediting the referral of clients to the management assistance staff. The report concluded that although more management assistance appears to be available now than previously, it is not always sufficient to meet borrowers' needs.

The Administrator, SBA, in response to our followup report, directed that his staff take the following actions for all GAO reports issued since 1975.

--Review each report recommendation and determine whether the necessary corrective action has been taken.

--In those situations where the recommended action has not been taken, evaluate the reasons and take appropriate action.

--In those cases where the recommendation may no longer be appropriate, give the reasons or justification for this determination.

--Establish an appropriate monitoring system on a continuing basis to assure that actions are implemented.

CONCLUSIONS

SBA does not appear to be doing as much as it could to help franchisees obtain and operate their businesses in the most effective manner.

SBA has not accumulated or disseminated information on franchisors and their operations or on the SBA loan success and failure rates for specific franchises. It has been making franchise loans for many years and should be privy to considerable information on franchisor operations. Also, it should have substantial information on the success and failure rates of franchisees with SBA loans.

In our opinion, SBA's accumulation and dissemination of such information could reduce the potential for loan defaults. Not only could such information dissuade some franchisee loan applicants from entering into potentially risky business ventures, but it could also help SBA loan personnel to determine which loan applications warrant closer scrutiny, including credit and market analyses. While some SBA officials believe that disclosure of SBA loan failure rates may be unfair to franchisors, we believe that such information, put in its proper perspective, could and should be made available to franchisee loan applicants.

Also, SBA could provide more, as well as more timely, assistance to franchisees. Although SBA recognizes that managerial deficiencies cause most businesses to fail and has made organizational changes to remedy this, it still does not provide enough information, counseling, and management assistance to prospective franchisees and other borrowers. By not doing so, SBA is not helping to reduce the franchise loan default rate. Field visits to franchisees, both before and during the loan approval process, help identify potential problems, both immediate and future, which could affect the borrower's repayment ability. We do not believe that visits to every SBA borrower are necessary. Once a need for assistance has been identified, however, either through a field

visit or at the request of the franchisee, help should be made available as quickly as possible.

In addition, SBA should not rely exclusively on banks or franchisors to resolve problems which may result in loan defaults. If franchisees are allowed to reach the point of impending financial failure, management assistance will be of little value in reducing the number of SBA-assisted franchise loan failures.

RECOMMENDATION

We recommend that the Administrator, SBA, establish at the headquarters office an information file on franchise loans, including loan failure rates for each franchisor and the reasons for each failure, to (1) be disseminated to district offices and prospective franchisee loan applicants for their use in making loan decisions and (2) help reduce the potential for loan losses.

The SBA Administrator has promised to take actions on previous GAO recommendations concerning management assistance in the 7(a) program, which may alleviate its problems. Accordingly, we are not making any recommendations on management assistance at this time, but we plan to follow up at a later date to see what actions SBA has taken.

AGENCY COMMENTS

SBA officials expressed concern that district offices provide prospective franchisees information on franchisors because it would create very difficult public relations problems in that it could be construed as an SBA recommendation of one franchisor over another. Also, they said that threatened lawsuits would doubtless proliferate to the benefit of no one. The officials said, however, that they had no objection to using the information within SBA.

We told these officials that the SBA data is public information and that under the Small Business Act, SBA is required to aid, counsel, and assist prospective borrowers. As a result, SBA should provide a prospective franchisee the loan default rate, whether good or bad, on the franchisor in question for use in making a loan decision.

With regard to district offices not making field visits, these officials said that they realized the importance of these visits but did not have, and probably would never have, sufficient staff to make as many field visits as desired. Also, one official said, because franchisors often visit

franchisees, SBA believes it can be more lax in visiting these borrowers than it can nonfranchise borrowers.

CHAPTER 5

SCOPE OF REVIEW

We reviewed SBA franchise loan policies and practices at (1) its headquarters in Washington, D.C., (2) three regional offices in Boston, Massachusetts; New York, New York; and San Francisco, California, and (3) the following 10 district offices.

Augusta, Maine	Los Angeles, California
Boston, Massachusetts	New York, New York
Concord, New Hampshire	Phoenix, Arizona
Des Moines, Iowa	Providence, Rhode Island
Hartford, Connecticut	San Francisco, California

These district offices were selected for review because of (1) the subcommittee staff's interest in them, (2) the large volume of franchise loans they made, or (3) their low loan default rates. Ninety-two loans totaling about $11 million were judgmentally selected for review in the 10 district offices. These loans were selected from those that had defaulted and those in a current status; all loans were made during fiscal years 1974-77. Both the defaulted and current loans selected were primarily from those types of businesses that received the largest number of SBA franchise loans--automobile dealers, gasoline stations, fast food franchises, and automobile-related businesses (tires and auto repair and painting).

The loan files were reviewed in detail to determine compliance with SBA Standard Operating Procedures, the Code of Federal Regulations, and provisions of the Small Business Act, as amended. There is no assurance that the results of our review of these 92 loans are representative of the other 16,287 franchise loans SBA has made.

Also, franchise loan applications declined during fiscal years 1977 and 1978 were reviewed to determine whether franchisees of small franchisors had been denied loans and the reasons for any such denials.

Thirty-three franchisee borrowers, including 18 that were no longer in business, were contacted to determine (1) how much management assistance and counseling SBA, the banks, and franchisors had provided them, (2) what additional assistance could have been provided, and (3) their suggestions for improving SBA's franchise loan practices.

In addition, we sent a questionnaire on franchisors' financial assistance practices to 94 of the largest franchisors, as determined by the number or dollar amount of SBA loans their franchisees obtained during the 10-year period ended November 1978; 75 responded.

APPENDIX I

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NINETY-FIFTH CONGRESS

Congress of the United States

House of Representatives

COMMERCE, CONSUMER, AND MONETARY AFFAIRS
SUBCOMMITTEE
OF THE
COMMITTEE ON GOVERNMENT OPERATIONS

RAYBURN HOUSE OFFICE BUILDING, ROOM B-377
WASHINGTON, D.C. 20515

February 13, 1979

Hon. Elmer B. Staats
Comptroller General
of the United States
General Accounting Office
441 G Street, N.W.
Washington, D. C. 20548

Dear Mr. Comptroller General:

The Commerce, Consumer and Monetary Affairs Subcommittee of the Government Operations Committee is presently examining the procedures and policies governing the Small Business Administration's loans to franchise operations under the SBA 7(A) loan program.

Computer printouts provided by the SBA to Representative Toby Moffett, a member of the subcommittee, showing a high rate of defaults among certain franchisees, suggest that SBA's performance under the 7(A) franchise program, deserves closer scrutiny. Representative Moffett's preliminary analysis shows, among other things, a disproportionate amount of loan money to the franchisees of very large corporations and also a very high default rate for some of these franchise operations and therefore raises a number of important questions.

Pursuant to the subcommittee's oversight responsibilities for the operations of SBA programs, we are requesting that GAO audit SBA's operations of its 7(A) programs as applied to franchisees. GAO should focus on the following questions:

1. Title 15 U.S. Code Section 642 requires that no SBA loan be granted until proof has been submitted that a loan cannot be obtained through private lending institutions. Is SBA indeed acting as a lender of last resort in granting loans to franchisees? (Information developed during our preliminary investigation seems to indicate otherwise.) Is it customary for such franchisors to lend money to their franchisees, and, if so, under what circumstances? (For example,

where there are franchisors which have SBA assisted franchisees, what percentage of all franchisees obtain financing from these franchisors rather than from the SBA? If it is not customary, could it be? Do SBA's files on franchise loans include proof of loan refusal from private lenders or others including the franchisor? Do those refusals include dates, amounts, terms and proof of refusal? Does SBA consider whether the franchisor is financially capable of financing the franchisee? If not, why not?

2. Our preliminary investigation shows that 5.6 percent of all franchisors participating in the 7(A) loan program over the past 10 years - 110 of 1,975 firms - account for about 75 percent of all money disbursed to franchises, $674 million of the $901 million. Many of these franchisors were very large corporations, such as automobile companies, oil companies, and fast food chains, that might have been able to finance all or a major part of the franchisees' costs connected with purchasing a franchise. How many prospective franchisees of small franchisors have been denied loans, because the available funds had already been approved or disbursed to prospective franchisees of large franchisors? In developing a size standard, does SBA consider the differences between franchises and independent businesses in terms of (1) competitive strength and (2) the size of the franchisor? Does SBA consider the financial condition of the franchisor? Has SBA considered requiring large franchisors to extend or guarantee credit to a franchisee as a condition for its own lending to the franchisee? If not, why not, and what recommendation would GAO have to remedy this situation?

3. On November 11, 1971, the FTC proposed rules (now becomming effective July 21, 1979), requiring franchisors to disclose certain information to the franchisees, including business records, the contract terms, fees required by those terms, indirect costs, the number and location of failing franchise operations, etc. Although SBA endorsed this rule in 1972, what steps has it taken to provide prospective franchisees who apply for SBA loans with this and other information about franchisors? Has SBA revealed to prospective franchisees of a company the failure rate of that company's franchisees which have an SBA loan outstanding and the reasons for these failures?

4. Closely related to the information sought in paragraph 3, what information, counseling, and management assistance has SBA provided to prospective franchisees? The February 1976 GAO audit of the 7(A) loan program cited failure to offer guidance as a major flaw of the program; what steps has SBA taken in response to that complaint in the GAO report?

5. Are SBA Standard Operating Procedures for granting 7(A) loans to franchisees adequate to ensure reasonable repayment of the loans? Are district and regional offices of the SBA, and their loan specialists, regularly provided with data on the SBA loan history of those franchisees,

having defaulted on their loans? If not, how could SBA improve its procedures? Next, before approval of a 7(A) loan, have marketing studies been required by SBA and, if so, are these adequately considered by the SBA loan specialists? Prior to the approval of a loan, does SBA perform on a national or regional basis marketing studies or credit analyses of franchisors, and also, does the SBA review the contract terms, including the franchisor's financial requirements? If not, why not? And what recommendations would GAO have to remedy this situation?

6. In conjunction with the issues raised in the paragraphs above, as well as in any other areas, what are the SBA guidelines for franchise loans? Are they adequate? Also, please evaluate SBA's record of compliance with these guidelines.

The SBA has already furnished some data on franchise loans to David Bollier, legislative assistant to Representative Moffett, who has partially evaluated this data. His evaluation has raised some of the above questions which we would like GAO to answer.

We would also request that, during the course of this project, GAO personnel involved jointly brief subcommittee staff and Mr. Bollier as to GAO's plans (including proposed scope and locations of examination) and subsequently as to GAO's findings. Finally, the subcommittee would like to receive a written report, containing its findings on the above issues and any recommendations which GAO has, to be submitted no later than December 31, 1979. We would additionally request that the report not be released for 30 days after it is submitted to the subcommittee, because of the sensitive nature of the subject.

Stephen R. McSpadden, counsel to the subcommittee, will be coordinating this matter for the subcommittee. Therefore, please contact Mr. McSpadden if any questions or problems arise during the course of your investigation.

Thank you for your cooperation and assistance.

Sincerely,

Benjamin S. Rosenthal
Chairman

Anthony (Toby) Moffett
Member of Committee

BSR:mv

APPENDIX II

U.S. GENERAL ACCOUNTING OFFICE

SUMMARY OF 75 RESPONSES TO

SURVEY OF FRANCHISORS' FINANCIAL ASSISTANCE PRACTICES

INTRODUCTION

The U.S. General Accounting Office is the agency of Congress responsible for evaluating Federal programs. A Congressional Subcommittee has asked us to evaluate the Small Business Administration's (SBA) practices and policies related to loans to franchise businesses.

The results of our review, which may include recommendations for revising SBA lending practices and policies, will be reported to the Subcommittee. This questionnaire is an opportunity for your company to provide information which could have a significant impact on any recommendations we might make.

This questionnaire is numbered only to aid us in our follow-up efforts and will not be used to identify you with your responses. Your answers will be held in confidence.

Throughout this questionnaire there are numbers printed within parentheses to assist our keypuncher in coding responses for computer analysis. Please disregard these numbers.

Please return the completed questionnaire in the enclosed self-addressed envelope within 5 days, if possible. If you have any questions, please call Dewey Gibson at (202) 632-7762.

BACKGROUND

1. What is the principal type of franchise or dealership your organization puts into operation? *(Check one.)*

1.	[18]	Fast food /Restaurant	(6)
2.	[10]	Auto and truck	
3.	[7]	Auto supply (including tires, painting, transmission repair and tune-ups)	
4.	[13]	Gasoline service stations	
5.	[3]	Hardware	
6.	[6]	Grocery	
7.	[2]	Farm equipment	
8.	[3]	Motorcycle	
9.	[3]	Motel/hotel	
10.	[10]	Other *(Specify.)* _____	

2. How many domestic franchises or dealerships did your organization open during the period January 1, 1974, to December 31, 1978? *(Enter Number.)*

(Total)

Number franchises or dealerships [4432 8] (7-10)

3. Please enter below (a) the number of domestic establishments (outlets) currently owned and operated by your company (franchisor), (b) the number of domestic establishments (outlets) operated by franchisees/dealers and (c) the total number of domestic establishments currently in operation. *(Enter Number.)*

(Totals)

(a) Number operated by company [1116 6] (11-14)

(b) Number operated by franchisee/dealer [8 3 3 0 1] (15-18)

(c) Total currently in operation [19 4 4 6 7] (19-22)

4. We are interested in knowing how much capital a franchisee/dealer must raise to go into business with your organization. Please enter below the minimum and average amount a franchisee/dealer must have for (a) franchisee/dealer fee and (b) other expenses (for building, inventory, etc.) not covered by a franchise/dealer fee. Note (a) & (b) should equal the amount you feel a franchisee/dealer must raise to open a business. *(Enter amounts to nearest thousand dollars.)* Amounts shown are averages for franchisors that had fees or expenses.

(a) Franchise fee (or dealer fee)

Minimum Amount	Average Amount	
$[18].000	$[22].000	(23-30)

(b) Other expenses

Minimum Amount	Average Amount	
$[1815].000 1/	$[11419].000 1/	(31-38)

DIRECT LOANS

5. Does your organization customarily make direct loans to franchisees/dealers? Do not include any financing or deferred payment plan you may provide for expenses paid directly to your organization such as franchise fee, inventory or rent/lease. *(Check one.)*

1.	[6]	Yes	(39)
2.	[69]	No *(If no, skip to 9.)*	

1/One response was omitted to avoid distorting averages.

APPENDIX II

6. Please enter below (a) the approximate number of new franchisees to whom you made such direct loans during the period January 1, 1974, to December 31, 1978, and (b) the total amount (estimated) of these direct loans. *(Enter amount to nearest thousand dollars.)*

(a) [1,1,1,5] 1/ Number to whom loans were made *(40-42)*

(b) $[59,9,6,1],000 1/ Total amount of loans *(43-46)*

7. In deciding whether or not to make a direct loan to a new franchisee, how much importance, if any, does your organization place on each of the following factors? *(Check one box per line.)* Based on six responses.

	1. Very Great Importance	2. Great Importance	3. Moderate Importance	4. Some Importance	5. Little or No Importance	
1. Amount of borrower's collateral	2	3	1			*(47)*
2. Credit rating of borrower	1	3	2			*(48)*
3. Duration of loan	1		4	1		*(49)*
4. Experience of borrower	2	3	1			*(50)*
5. Other *(Please specify.)* _____	1	1				*(51)*

8. For which of the following purposes did you make direct loans to new franchisees during the period January 1, 1974, to December 31, 1978? *(Check all that apply; then skip to question 10.)*

1 [1] Finance construction *(52)*
2 [6] Buy machinery and equipment *(53)*
3 [ ] Buy buildings *(54)*
4 [ ] Buy land *(55)*
5 [6] Buy inventory *(56)*
6 [5] Working capital *(57)*
7 [ ] Refinance an SBA loan *(58)*
8 [ ] Repay a bank loan *(59)*
9 [ ] Pay other debts *(60)*
10 [6] Other *(Explain.)* _____ *(61)*

SKIP TO QUESTION 10 AFTER ANSWERING QUESTION 8

9. To what extent, if at all, does each of the following factors explain why your organization does not customarily make direct loans to franchisees? *(Check one box per line.)*

	1. Very Large Extent	2. Substantial Extent	3. Moderate Extent	4. Some Extent	5. Little or No Extent	
1. Do not have adequate financial resources	13	10	6	9	17	*(62)*
2. Do not have administrative structure to manage loans	6	7	7	10	23	*(63)*
3. Belief that sufficient loans for franchises are available elsewhere	35	12	5	3	5	*(64)*
4. Other *(Please Specify.)* _____	11	2				*(65)*

10. Would your organization currently make a direct loan to what you consider a qualified franchisee? *(Check one.)*

1 [2] Definitely yes *(66)*
2 [5] Probably yes
3 [5] Uncertain
4 [29] Probably no
5 [29] Definitely no

OTHER FINANCING

11. Does your organization customarily finance any fees a franchisee must pay directly to your organization? *(Check one.)*

1 [6] Yes *(67)*
2 [68] No *(If no, skip to question 15.)*

1 (80)
Dup (1-5)

1/ Totals for seven responses including data reported by one franchisor that answered "no" to question 5.

APPENDIX II

12. Please enter below (a) the approximate number of new franchisees you financed during the period January 1, 1974, to December 31, 1978, and (b) the approximate total amount financed during this period. *(Enter amount to the nearest thousand dollars.)*

(a) [7,5,6] 1/ Number financed *(6-8)*

(b) $ [63,6,1,3] ,000 1/ Total amount financed *(9-12)*

13. In deciding whether or not to provide financing to new franchisees, how much importance, if any, does your organization place on each of the following factors? *(Check one box per line.)* Based on five responses.

	1. Very Great Importance	2. Great Importance	3. Moderate Importance	4. Some Importance	5. Little or No Importance	
1. Amount of borrower's collateral	1	3	1	1		*(13)*
2. Credit rating of borrower		5	1			*(14)*
3. Duration of payment period	1	1	2	2		*(15)*
4. Experience of borrower	1	1	3	1		*(16)*
5. Other *(Please Specify.)* ____		1				*(17)*

14. Which of the following has your organization financed for new franchisees during the period January 1, 1974, to December 31, 1978? *(Check all that apply, then skip to question 16.)*

1. [ ] Franchise fee *(18)*
2. [5] Initial inventory *(19)*
3. [ ] Rent/lease *(20)*
4. [6] Equipment *(21)*
5. [1] Other *(Please specify.)* _____ *(22)*

AFTER ANSWERING QUESTION 14, SKIP TO QUESTION 16.

15. To what extent, if at all, does each of the following factors explain why your organization does not customarily offer financing to franchisees? *(Check one box per line.)*

	1. Very Large Extent	2. Substantial Extent	3. Moderate Extent	4. Some Extent	5. Little or No Extent	
1. Do not have adequate financial resources	14	7	7	3	19	*(23)*
2. Do not have administrative structure to manage financing arrangements	6	6	8	6	21	*(24)*
3. Belief that sufficient loans for franchises are available elsewhere	31	12	5	2	4	*(25)*
4. Other *(Please Specify.)* _____	9				1	*(26)*

16. Would your organization currently offer financing to what you consider a qualified franchisee? *(Check one.)*

1. [8] Definitely yes *(27)*
2. [5] Probably yes
3. [7] Uncertain
4. [23] Probably no
5. [24] Definitely no

GUARANTEED LOANS

17. Does your organization customarily guarantee, fully or partially, repayment of loans made to new franchises? *(Check one.)*

1. [9] Yes *(28)*
2. [65] No *(If no, skip to question 21.)*

1/Totals for eight responses, including three that do not now finance franchisees. One franchisor that does offer financing did not provide data.

APPENDIX II

18. Please enter below, for each loan guarantee percentage shown (a) the approximate number of loans to new franchisees your organization guaranteed during the period January 1, 1974, to December 31, 1978, and (b) an estimate of the dollar amount actually guaranteed. *(Enter dollar amounts to nearest thousand dollars. If none enter 0.)*

Percent of Loan Amount Guaranteed	(a) Number of Loans (Totals)		(b) Estimate of Total Amount Guaranteed	
Fully guaranteed (100%)	196 *(29-31)*	6*	$ 919,618 .000 *(44-47)*	
76 - 99 percent	64 *(32-34)*	2*	$ 40,840 .000 *(48-51)*	
51 - 75 percent	9 *(35-37)*	2*	$ 7,000 .000 *(52-55)*	
25 - 50 percent	95 *(38-40)*	3*	$ 99,100 .000 *(56-59)*	
Less than 25 percent	15 *(41-43)*	1*	$ 10,000 .000 *(60-63)*	

*The number of respondents

19. In deciding whether or not to guarantee loans to new franchisees, how much importance, if any, does your organization place on each of the following factors? *(Check one box per line.)*

	1. Very Great Importance	2. Great Importance	3. Moderate Importance	4. Some Importance	5. Little or No Importance	
1. Amount of borrower's collateral	2	4	1	1	1	*(64)*
2. Credit rating of borrower	2	2	3	1	1	*(65)*
3. Duration of loan	1	1	5	1	1	*(66)*
4. Experience of borrower	3	2	3		1	*(67)*
5. Other *(Please Specify.)* _____	5					*(68)*

2 (80)
Dup (1-5)

20. Which of the following types of loans to new franchisees did your organization guarantee during the period January 1, 1974, to December 31, 1978? *(Check all that apply, then skip to question 22.)*

1	[2]	Construction loans	*(6)*
2	[7]	Loans to buy machinery and equipment	*(7)*
3	[3]	Loans to buy buildings	*(8)*
4	[2]	Loans to buy land	*(9)*
5	[4]	Loans to buy inventory	*(10)*
6	[4]	Loans for working capital	*(11)*
7	[ ]	Loans to refinance an SBA loan	*(12)*
8	[ ]	Loans to repay a bank loan	*(13)*
9	[1]	Debt consolidation loans	*(14)*
10	[10]	Other *(Please specify.)* _____	*(15)*

AFTER ANSWERING QUESTION 20, SKIP TO QUESTION 22

APPENDIX II

21. To what extent, if at all, does each of the following factors explain why your organization does not guarantee loans made to new franchisees? *(Check one box per line.)*

	1. Very Large Extent	2. Substantial Extent	3. Moderate Extent	4. Some Extent	5. Little or No Extent	
1. Do not have adequate assets to offset loan guarantee liabilities	10	8	6	5	18	*(16)*
2. Do not have administrative structure to manage loan guarantees	6	4	5	15	17	*(17)*
3. Belief that sufficient loans for franchisees are available without our guarantees	33	13	5	2	3	*(18)*
4. Other *(Please Specify.)* _____ _____ _____	8	1			1	*(19)*

22. Would your organization currently guarantee a non-government loan made to what you consider a qualified franchisee? *(Check one.)*

1. [4] Definitely yes *(20)*
2. [7] Probably yes
3. [5] Uncertain
4. [25] Probably no
5. [25] Definitely no

SBA LOANS

23. Currently, SBA makes direct loans to franchisees without requiring franchisor involvement. A suggestion has been made that SBA require the franchisor to guarantee at least part of the loan amount as a condition of SBA making a direct loan to a franchisee. To what extent do you support or oppose the implementation of such a requirement? *(Check one.)*

1. [2] Strongly support *(21)*
2. [1] Generally support
3. [3] Support as much as oppose
4. [18] Generally oppose
5. [48] Strongly oppose

24. In addition to making direct loans, SBA will guarantee up to 90 percent of bank loans made to franchisees. A suggestion has also been made that SBA require franchisors to share at least part of this guarantee. To what extent do you support or oppose the implementation of such a requirement? *(Check one.)*

1. [1] Strongly support *(22)*
2. [1] Generally support
3. [5] Support as much as oppose
4. [19] Generally oppose
5. [46] Strongly oppose

COMMENTS

25. If you have any additional comments on any of the items within this questionnaire or related topics not covered, please express your views in the space below. *(Attach an additional sheet if necessary.)* Your answers and comments will be greatly appreciated.

(See app. III.)

(23)
3 (80)

EXAMPLES OF FRANCHISOR COMMENTS MADE IN RESPONSE TO GAO'S QUESTIONNAIRE

"* * * let me say that without the SBA it is very unlikely that our chain would have grown as rapidly as it has. * * * over 75% of our franchisees have been financed with the assistance of the Small Business Administration.

* * * * *

"In recent months, however, we have run into many problems in various offices of the SBA * * *.

"I would like to see a firm set of conditions that would be consistent in all SBA offices so that we would know before we even sign the prospect what concessions would be necessary on our part to make the franchisee eligible for an SBA loan or guarantee."

\- - - -

"* * * the enormous amount of 'Red Tape' should be substantially cut down when applying for SBA financing. * * * too much bureaucracy plagues the SBA."

\- - - -

"We would be extremely interested in cooperating with the SBA to form some type of a program on a national rather than a regional basis, which would make SBA direct loans or SBA guaranteed loans more readily available to qualified franchisees. At the present time, the amount of red tape, time delay, and differences of opinion that exist from one SBA office to another, make it very impractical for a National Franchisor to recommend the bank loan SBA guaranteed procedure."

\- - - -

"A franchise organization with a good track record with the SBA and the industry, with a lower failure and/or default rate than the norm, should be able to arrange financing with SBA guarantees more quickly

and much more often than other organizations with less attractive records or ones new on the scene.

* * * * *

"Guarantees by the franchisor would not be a positive step, since it would severely limit growth and expansion. Further, if the franchisor has to guarantee the loan also, then there is no need for the SBA to exist."

- - - -

"Prior to 1979 we made direct loans, and guaranteed loans for new Dealers. We believe there are sufficient funds available on a local level without our guarantees.

* * * * *

"It is possible that we would guarantee a loan for a new Dealer, buying an existing store."

- - - -

"Opposition to franchisor guarantees of franchisees' SBA- or other- loans (is) based upon lack of management control of operations of franchised facility."

- - - -

"To strengthen the SBA program quit doling out loans based upon quotas and begin giving them to individuals with some potential to succeed."

- - - -

"* * * the franchisee is at the mercy of a SBA Regional Office which knows little of the franchisor background."

- - - -

"In the interest of maintaining operational integrity with all dealers--it is not possible to have a financial interest in a select number of dealers. Also, criteria for qualification would be very difficult to develop."

- - - -

"We have had very poor experience with dealers who had SBA loans."

- - - -

"We have had excellent cooperation and assistance from the various offices of the Small Business Administration * * * any requirement by the SBA that we as franchisor guarantee all or in part the financing of the individual franchisees would soon make it impossible for us to continue to expand."

- - - -

"The * * * SBA office is responsible for several of our successful franchisees. Without their help, the loans would not have been made * * *.

"We greatly appreciate the program."

FRANCHISORS THAT RESPONDED TO GAO's QUESTIONNAIRE

A & W International, Inc.

Ace Hardware Corporation

American Honda Motor Company, Inc.

American Motors Corporation

Athlete's Foot Marketing Associates, Inc.

Atlantic Richfield Company

Baskin-Robbins, Inc.

Ben Franklin Stores

Bonanza International, Inc.

Breslers's 33 Flavors, Inc.

Burger King Corporation

Casey's General Stores, Inc.

Champlin Petroleum Company

Chrysler Corporation

Coast to Coast Stores

Continental Oil Company

Convenient Food Mart, Inc.

Country Kitchen International, Inc.

Culligan International Company

Deere and Company

Der Wienerschnitzel International, Inc.

Dunkin Donuts of America, Inc.

Exxon Corporation

Fairway Foods, Inc.

Firestone Tire and Rubber Company

Ford Motor Company

Fox Grocery Company

Gamble's Stores

General Motors Corporation

Goodyear Tire and Rubber Company

Gulf Oil Corporation

Happy Joe's Pizza and Ice Cream Parlors

International Harvester Company

Kampgrounds of America, Inc.

Karmelkorn Shoppes, Inc.

Kawasaki Motor Corporation, U.S.A.

K-Bob's, Inc.

KFC Corporation

Maaco Enterprises, Inc.

Martin Franchises, Inc.

Massey-Ferguson, Inc.

APPENDIX IV

Mercedes Benz of North America, Inc.

Midas International Corporation

Midland Automotive Warehouse, Inc.

Mobil Oil Corporation

Nissan Motor Corporation of U.S.A. (Datsun)

Otasco

Pepsico, Inc.

Peter J. Schmitt, Inc. (Bell's Market)

Piggly Wiggly Corporation

Pizza Hut, Inc.

Ramada Inns, Inc.

Schwinn Bicycle Company

Shell Oil Company

Sheraton Inns, Inc.

Standard Oil Company of California

Standard Oil Company of Indiana

Standard Oil Company of Ohio

Stretch and Sew, Inc.

Sun Company, Inc.

Super 8 Motels, Inc.

Swensen's Ice Cream Company

Swiss Colony Stores, Inc.

Taco John's

Tastee Freez International, Inc.

Taylor Rental Corporation

Texaco, Inc.

Tiffany's Bakeries, Inc.

Toyota Motor Sales

Union Oil Company of California

U.S. Suzuki Motor Corporation

Volkswagen of America, Inc.

Wiener King Corporation

White Home and Auto

White Motor Corporation

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